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No. 01-

IN THE

Supreme Court of the United States

SCHOLASTIC CORPORATION and
RAYMOND MARCHUK,

Petitioners,

v.

RICHARD TRUNCELLITO and
THE CITY OF PHILADELPHIA,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

MICHAEL J. CHEPIGA
Counsel of Record
DAVID E. MASSENGILL
DAVID ELBAUM
SIMPSON THACHER & BARTLETT
425 Lexington Avenue
New York, NY 10017
(212) 455-2000

Of Counsel:

PROFESSOR ELLIOTT J. WEISS
CHARLES E. ARES PROFESSOR OF LAW
JAMES E. ROGERS COLLEGE OF LAW
UNIVERSITY OF ARIZONA
1200 East Speedway Boulevard
Tucson, AZ 85721
(520) 621-3578

Attorneys for Petitioners

169054

COUNSEL PRESS
(800) 274-3321 • (800) 359-6859

1190P

QUESTIONS PRESENTED

In 1995 the United States Congress passed, over a presidential veto, the Private Securities Litigation Reform Act. An undisputed purpose of that Act was to create uniform pleading standards that would curb abusive lawsuits, such as suits based on "fraud by hindsight" allegations. The pleading standards require plaintiffs to set forth particularized facts (i) that specify each allegedly misleading statement, including specifically why and how each statement was misleading, (ii) that disclose the basis for all allegations made on information and belief, and (iii) that give rise to a strong inference of *scienter* for each allegedly misleading statement.

I. Is the Second Circuit's pleading standard for securities fraud lawsuits — a standard that is in direct conflict with decisions of at least four other courts of appeals — inconsistent with the plain language of the statute, permitting plaintiffs to allege securities fraud without pleading either (i) particularized facts specifying how each statement was misleading or (ii) particularized facts giving rise to a strong inference of scienter?

II. Is the Second Circuit's decision inconsistent with the plain language of the statute because it holds, in direct conflict with other courts of appeals, that:

   A. A complaint may survive dismissal based solely on inferences that are "not unreasonable," rather than on "strong" inferences;

B. A complaint may survive dismissal even though allegations made on information and belief do not include "all facts" on which the belief is formed; and

C. A complaint may survive dismissal where *scienter* is alleged solely by pleading that a defendant had "motive and opportunity" to commit fraud?

PARTIES TO THE PROCEEDING BELOW

Petitioners Scholastic Corporation and Raymond Marchuk are the only named defendants in a complaint filed by respondents Richard Truncellito and the City of Philadelphia, court-appointed lead plaintiffs purporting to act on behalf of themselves and a class of all others similarly situated. Richard Robinson and Kevin McEnery were defendants in one or more earlier complaints but they were not defendants in the Corrected Second Consolidated Amended Class Action Complaint that was the subject of the decision below. Lawrence B. Hollin was the named plaintiff in an earlier complaint but was not a named plaintiff in the complaint that was the subject of the decision below.

STATEMENT PURSUANT TO RULE 29.6

Pursuant to Rule 29.6, petitioner Scholastic Corporation certifies that it has no parent corporation and that no publicly held company owns 10 percent or more of its stock.

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Scholastic Corporation and Raymond Marchuk respectfully petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit.

OPINIONS BELOW

The decision of the court of appeals is reported at 252 F.3d 63 (2d Cir. 2001). The district court decision dismissing the Consolidated Amended Class Action Complaint is reported at 1998 WL 872422 (S.D.N.Y. Dec. 15, 1998). The district court decision dismissing the Corrected Second Consolidated Amended Class Action Complaint is reported at 2000 WL 91939 (S.D.N.Y. Jan. 27, 2000). Copies are in the Appendix ("App.").

STATEMENT OF JURISDICTION

The court of appeals entered its judgment on June 1, 2001. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

This case involves Section 21D of the Securities Exchange Act of 1934, 15 U.S.C. § 78u-4, which was added by the Private Securities Litigation Reform Act of 1995 (PSLRA), Pub. L. 104-67, 109 Stat. 737. Section 21D provides, in relevant part:

> (b) *Requirements for securities fraud actions.*
>
> (1) *Misleading statements and omissions.* In any private action arising under this chapter in which

the plaintiff alleges that the defendant — (A) made an untrue statement of a material fact; or (B) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading; the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

(2) *Required state of mind.* In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

(3) *Motion to dismiss; stay of discovery.* (A) *Dismissal for failure to meet pleading requirements.* In any private action arising under this chapter, the court shall, on the motion of any defendant, dismiss the complaint if the requirements of paragraphs (1) and (2) are not met.

15 U.S.C. § 78u-4(b)(1)-(3).

STATEMENT OF THE CASE

Section 10(b) of the Securities Exchange Act forbids deceptive conduct in connection with the purchase or sale of a security. 15 U.S.C. § 78j(b); *see also* Securities and Exchange Commission ("SEC") Rule 10b-5, 17 C.F.R. § 240.10b-5. The elements of a § 10(b) claim have been clarified by this Court. *See, e.g., Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988). However, by 1995 various courts of appeals had adopted widely differing standards for pleading those claims.

In 1995 Congress looked at these pleading standards in detail, concerned that they created "opportunities for abuses." S. Rep. No. 104-98, at 4 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 683. There was "substantial testimony" about "strike suits" filed "in the hope that defendants will quickly settle to avoid the expense of litigation." *Id.* Congress was particularly concerned about "fraud by hindsight" suits that were "often based on nothing more than a company's announcement of bad news, not evidence of fraud." *Id.*

Congress passed the PSLRA to establish "*uniform and more stringent* pleading requirements to curtail the filing of meritless lawsuits." H.R. Rep. No. 104-369, at 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 740 (emphasis added). This was confirmed in 1998 when Congress preempted state securities law claims to insure that the PSLRA's "more stringent" pleading standards would be uniformly applied. *See* 15 U.S.C. § 78bb(f)(1); 15 U.S.C. § 78a note (Congressional findings).

The decision below makes clear that the Second Circuit has established pleading standards that are *less* stringent than Congress intended and that directly conflict with decisions of other circuits. In the same week this decision was handed

down, the Sixth Circuit Court of Appeals, sitting *en banc*, unanimously rejected the Second Circuit's positions. *Helwig v. Vencor, Inc.*, 251 F.3d 540, 551-52 (6th Cir. 2001) (*en banc*). And in that same week the Ninth Circuit issued a decision confirming *its* rejection of the Second Circuit's standards. *Ronconi v. Larkin*, 253 F.3d 423, 429 (9th Cir. 2001). There are earlier decisions from the First and Eleventh Circuit Courts of Appeals applying standards that are different from the Second Circuit's standards. *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 196-97 (1st Cir. 1999); *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1283 (11th Cir. 1999).

These other courts of appeals enforce the "more stringent" pleading standards of the PSLRA. They require securities fraud complaints that contain detailed factual allegations, that support any allegations made on information and belief with facts, and that plead facts creating a strong inference of *scienter*.

In stark contrast the Second Circuit, applying traditional notice pleading analysis, reinstated a complaint that alleged fraud by hindsight, that did not plead a factual basis for its allegations, and that alleged *scienter* — the state of mind necessary for fraud — with nothing more than inferences about what Scholastic *should have* known.

The conflict among the circuits has very real effects. The complaint that the Second Circuit reinstated in this action would have been dismissed in at least four other circuits. The creation of *less* stringent pleading standards than required by the PSLRA — in the circuit that is a home to the world's securities markets — has created confusion and conflict among district courts and circuit courts. These issues are ripe for resolution by this Court.

A. Procedural History of the Complaints and the Decisions Below

On February 20, 1997, Scholastic issued a press release warning investors about expected lower earnings. App. 7a. On April 7, 1997, it was sued for securities fraud in the Southern District of New York. App. 70a.

A Consolidated Amended Complaint was filed on August 13, 1997, against Scholastic and two of its executives: Chief Financial Officer Kevin McEnery and Raymond Marchuk, Vice President for Finance and Investor Relations. *Id.* On December 15, 1998, District Judge John F. Keenan dismissed that complaint, with leave to replead, for failing to meet the requirements of 15 U.S.C. § 78u-4(b)(1) ("§ (b)(1)") and § 78u-4(b)(2) ("§ (b)(2)"). App. 78a.

A Corrected Second Consolidated Amended Complaint was filed on March 8, 1999, naming only Scholastic and Marchuk. App. 4a. On January 27, 2000, District Judge Keenan dismissed that complaint, with prejudice, for failing to meet the requirements of §§ (b)(1) and (b)(2). App. 57a.

On June 1, 2001, the Second Circuit Court of Appeals reversed, and reinstated the complaint. App 1a, 27a. Citing its decisions in *Novak v. Kasaks*, 216 F.3d 300, 305 (2d Cir.), *cert. denied*, 121 S. Ct. 567 (2000), and *Rothman v. Gregor*, 220 F.3d 81, 88 (2d Cir. 2000), the Second Circuit held that the district court had applied "a more stringent standard than the law requires." App. 11a.

B. The Allegations in the Second Amended Complaint

Scholastic has been in business for over 80 years. It is a leading publisher and distributor of children's books, including best-selling series such as *Clifford The Big Red Dog*, *The Baby-sitters Club* and *The Magic School Bus*. App. 5a. Scholastic primarily distributes books to consumers through direct channels, including school book clubs and book fairs. App. 59a-60a. In 1996, about 20% of its domestic book sales came from books sold through the "trade" channel, primarily to wholesale distributors and retailers. App. 60a.

In the publishing industry, trade books are generally sold with a full right of return. App. 60a-61a. If the retailer does not sell the book it can be returned for a refund. App. 60a. Under Generally Accepted Accounting Principles, revenues from sales of trade books are reported as gross billings minus a reserve for anticipated returns. *Id.* The reserve, an estimate of future results, is based on a number of factors, but the most significant is the Company's past experience.

The complaint focuses on the *Goosebumps* books, Scholastic's largest selling series of trade books in 1995 and 1996. App. 5a. The complaint alleges that sales of *Goosebumps* books, which were strong in September 1995, were in a decline by September 1996. App. 6a, 11a-13a.

In September 1996, Scholastic announced the results for its first quarter, which ended August 31. App. 6a, 61a. In that announcement Scholastic noted that its *Goosebumps* books were selling well. App. 61a. Plaintiffs do not allege that this statement or the announced results were in any way inaccurate or misleading.

Indeed, on November 27, 1996, less than two weeks before the start of the alleged class period, Scholastic signed a new, long-term contract with the licensors of the *Goosebumps* series. App. 37a. The contract called for Scholastic to publish and distribute dozens of new books. Scholastic agreed to pay substantially higher royalty rates than the prior contract and increased advances totaling $36.1 million. *Id.*

Scholastic's second quarter covered September through November. On December 10, 1996, Scholastic announced its second quarter results. App. 7a. Net income and sales revenues had increased compared to September through November 1995. App. 7a, 38a.

On December 31, and January 2, 3, and 7, Marchuk sold 19,400 shares of Scholastic stock (80% of his holdings). App. 19a. Plaintiffs alleged that he received over $1,250,000 in gross proceeds, but did not allege his purchase price. *Id.*

On January 14, 1997, Scholastic filed its quarterly report on SEC Form 10-Q for the second quarter, repeating the net income and sales figures disclosed in December. App. 10a.

The complaint did not allege that any of the sales, revenue and net income figures in the December announcement, or in the January 14, 1997 Form 10-Q, were inaccurate.

On February 20, 1997, weeks before it was scheduled to announce its third quarter results, Scholastic issued a press release. App. 7a. The press release stated that during the third quarter, which included the holidays, sales through the trade and book club channels had decreased compared to the previous year's third quarter. App. 41a. Scholastic said it would have lower revenues and would take a charge against earnings for an increased reserve for returns in the third quarter. App. 7a.

Plaintiffs alleged that Scholastic committed fraud during the period December 10 to February 20, not because any of the actual sales, revenue or income figures were incorrect, but because the February 20 negative announcement reflected a "trend" that Scholastic should have known about by December 10. App. 41a-42a.

Plaintiff's allegations about this "trend" fell into three groups. First, they said there was a decline in sales from 1995 to September 1996, but said nothing about returns in that period. The September 1996 sales were fully and accurately disclosed by December 10. Second, they did not allege any declining sales or rising returns during October to December, other than vaguely noting "unusually high" returns from one retailer in December. Third, they alleged increased returns in January, but they said Scholastic did not learn about those returns until February. And they alleged there were two cases where January orders were lower than September orders, but they did not say when Scholastic learned about that. App. 11a-14a.

Plaintiffs' fraud claims rested on Scholastic's failure to disclose this "trend" in its public statements and in statements by securities analysts who covered Scholastic. App. 38a-43a. Plaintiffs claimed that Scholastic should be held responsible for the analysts' statements. Plaintiffs did not claim that the actual sales or earnings figures for the second quarter, which the analysts reported on and discussed, were inaccurate.

The first paragraphs of the complaint set forth the basis for the allegations of fraud. Other than their own trading records, which were alleged on personal knowledge, Plaintiffs' allegations were based upon their counsel's review of SEC filings, Scholastic's press releases, analysts' reports,

reports from news media, and interviews with non-parties. Plaintiffs did not claim that any of the allegations was based upon a review of any internal Scholastic documents. Nor did they claim that any of the allegations was based upon any conversations by counsel with anyone who worked at Scholastic.

C. The Decision by the Second Circuit Court of Appeals

The PSLRA established "*uniform and more stringent* pleading requirements to curtail the filing of meritless lawsuits." H.R.Rep. No. 104-369, at 41, *reprinted in* 1995 U.S.C.C.A.N. 730, 740. The Second Circuit, reversing the district court and reinstating the complaint, stated that the district court had held Plaintiffs "to a more stringent standard than the law requires." App. 11a. According to the Second Circuit, the appropriate standard was:

> Accepting all of the allegations in the complaint as true and *drawing all reasonable inferences in favor* of plaintiffs, *see Press v. Chem. Inv. Servs. Corp.*, 166 F.3d 529, 534 (2d Cir.1999), dismissal is proper "*only if it is clear* that no relief could be granted *under any set of facts* that could be proved consistent with the allegations," *Hishon v. King & Spalding*, 467 U.S. 69, 73, 104 S.Ct. 2229, 81 L.Ed.2d 59 (1984).

App. 8a (emphasis added)

The Second Circuit said it was applying the pleading standards that Congress erected as barriers to abusive lawsuits: §§ (b)(1) and (b)(2). But those sections require plaintiffs to plead, with specificity, facts showing how each alleged misstatement was fraudulent.

1. *The Second Circuit's interpretation of § (b)(1)*

Section (b)(1) requires plaintiffs to state specifically — for every alleged misstatement — the facts about when it was made, who made it, and precisely how and why it was misleading when it was made. The assumption behind § (b)(1) is that these specifics will be actual facts. If *any* of those specifics are not allegations of fact, but are instead inferences from facts — *i.e.*, they are pleaded on "information and belief" — then the complaint must state "with particularity all facts on which that belief is formed." This requires plaintiffs to have a specific factual basis for every allegation of fraud, which provides a factual foundation for the "strong inference" analysis required by § (b)(2). *See generally* Elliott J. Weiss, *Pleading Securities Fraud*, 64 LAW & COMTEMP. PROBS. 5 (2001).

In this case, Plaintiffs alleged that there was a "trend" of dropping sales and rising returns that should have been disclosed on December 10. The district court held that these allegations did not satisfy § (b)(1). App. 52a. If Plaintiffs were alleging that Scholastic committed fraud on December 10 by failing to disclose something, the complaint should state specifically what Scholastic knew *on December 10* that should have been disclosed. The complaint should allege specifically what Scholastic failed to say *on December 10* that made the statements misleading.

But the decline in sales alleged by Plaintiffs was from 1995 to September 1996, and there were no specific allegations about any additional declines in sales during October to December. The allegations about declining sales in January did not state with specificity the size of the decline or give any date on which Scholastic actually knew about those declines.

As to rising returns, the district court noted that the only specific allegations of rising returns were in January and February, and Plaintiffs stated Scholastic did not know about the January returns until February. They did not state when the February returns were known. The district court held that since there were no specific allegations about what Scholastic failed to disclose during the class period, the complaint failed to meet § (b)(1). App. 47a-52a.

The Second Circuit, however, accepted Plaintiffs' claim that it was possible to *infer* from pre- and post-class period facts that at some point during the class period Scholastic should have known something about the alleged "trend." App. 14a-15a. The Second Circuit specifically allowed fraud by hindsight, stating that "post-class period data may be relevant to determining what a defendant knew or *should have* known during the class period." App. 17a.

The Second Circuit also specifically rejected the requirement of § (b)(1) that any inferences — allegations pleaded on information and belief — must be accompanied by particularized facts supporting that inference. The court held, contrary to the plain words of the statute, that "[n]otwithstanding the use of the phrase 'all facts,' plaintiffs need not plead with particularity every single fact upon which they base their beliefs." App. 22a.

Instead, the Second Circuit allowed Plaintiffs to support their allegations on information and belief with *other* allegations also clearly pleaded on information and belief. Thus, Plaintiffs relied heavily on allegations about internal Scholastic reports, but never pleaded that they ever saw those reports, or that they knew what any of those reports said. The very existence of those reports, as well as their possible

contents, were alleged on information and belief. But the Second Circuit accepted these speculations as true, and in fact accepted them as adequate support for all the other allegations. *See, e.g.*, App. 22a-23a. Ignoring the demand for a "strong inference" of fraud, the Second Circuit permitted — as "not unreasonable" — the inference that Scholastic knew or should have known about a trend of declining sales on December 10. App. 17a.

2. The Second Circuit's interpretation of § (b)(2)

Section (b)(2) requires a "strong inference" of *scienter* based on detailed *facts*. This emphasis on facts continues the requirements of § (b)(1). It is not possible to have a "strong inference" that someone lied intentionally (or its equivalent), when the very existence of the alleged misstatement is based on paper-thin inferences from unsupported allegations.

But as to *scienter*, the Second Circuit held that pre-PSLRA "Second Circuit *case law remains the standard* after passage of the Act." App. 19a (emphasis added). The Second Circuit stated that plaintiffs could thus plead *either* (a) motive and opportunity *or* (b) facts "to show strong circumstantial evidence of defendants' conscious misbehavior or recklessness." *Id.*

Strong circumstantial evidence. The Second Circuit defined "strong circumstantial evidence" to include allegations that defendants "knew or *should have* known they were misrepresenting material facts with respect to the corporate business." App. 23a. And rather than facts, the Second Circuit allowed Plaintiffs to support this claim with any inference that was "not unreasonable." App. 17a.

Plaintiffs argued that *scienter* could be inferred from statements allegedly made by someone at Scholastic to a securities analyst shortly before the February 20 announcement. The court, accepting this argument, called those statements "egregious." App. 24a. But the alleged statements were inferences, not facts. Plaintiffs relied entirely on an ambiguous sentence in an analyst's report issued after the announcement. They did not plead specific facts about who made the alleged statements, when they were made, or what was said.

In contrast, the court refused to consider a stronger inference undercutting Plaintiffs' theory that Scholastic "knew or should have known" about declining sales and rising returns of *Goosebumps* books on December 10. On November 27, 1996, Scholastic signed a $36.1 million, multi-year contract to acquire, publish and sell dozens more *Goosebumps* books. App. 37a. A "strong inference" could be drawn that Scholastic did *not* know about declines in sales and rising returns when it signed a contract of this magnitude, less than two weeks before December 10.

Motive and opportunity. The Second Circuit treated "motive and opportunity" as an alternative to pleading "strong circumstantial evidence." App. 19a. The words "strong inference" never appear in the court's discussion of this test. The Second Circuit recognized that opportunity was easy to plead: "With respect to opportunity, Marchuk as an officer of Scholastic had access to insider information and thus had an opportunity to commit fraudulent acts." App. 19a.

As to motive, the Second Circuit asked only "whether *any* motive existed for such conduct" (emphasis added). Motive was defined as *any* "concrete benefit defendant would

realize by his conduct." App. 19a. The Second Circuit agreed that Marchuk's stock sales in late December and early January met this test. App. 23a. The court did not ask for any further evidence of motive or support for *scienter*.

REASONS FOR GRANTING THE WRIT

Within one week this summer, three circuit court decisions were issued dealing with the PSLRA's pleading standards: *In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63 (2d Cir. June 1, 2001) (App. 1a-27a), *Helwig v. Vencor, Inc.*, 251 F.3d 540 (6th Cir. May 31, 2001) (*en banc*), and *Ronconi v. Larkin*, 253 F.3d 423 (9th Cir. June 6, 2001). Those decisions crystallized the conflict between the circuits that had been developing for the last three years.

In *Helwig*, all 13 judges of the Sixth Circuit agreed on what they considered the appropriate interpretation of the PSLRA. Following the First Circuit, they rejected the Second Circuit's position. 251 F.3d at 551-52 (citing *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 196 (1st Cir. 1999)). Seven of the thirteen judges agreed that the complaint in that case met the higher standard because it specifically identified statements — by date, location, speaker and specific words — that were made by executives who then issued directly contradictory public statements. 251 F.3d at 545-46, 557-58, 562. Six judges disagreed with the application of the standard to those facts, and would have dismissed the complaint. *Id.* at 571-72.

In *Ronconi*, the Ninth Circuit affirmed the dismissal of a claim alleging defendants failed to disclose problems with a merger. 253 F.3d at 437. The Ninth Circuit stated that "fraud by hindsight" was not acceptable, *id.* at 430 n.12,

and held that "the complaint must contain allegations of specific 'contemporaneous statements or conditions' that demonstrate the intentional or the deliberately reckless false or misleading nature of the statements when made." *Id.* at 432 (internal quotation marks omitted). The Ninth Circuit held that stock sales by *seven* different insiders did not support a strong inference of fraud, even though the Executive Vice President and General Counsel sold 98% of her shares during the alleged fraud. *Id.* at 435-37.[1]

The Second Circuit is home to the global securities markets and the financial services industry. Virtually *any* securities fraud suit involving a publicly traded company can be filed in the Second Circuit. And the court's decisions have created the most lenient pleading standards in the nation. The plaintiffs' bar, recognizing this, is already moving to bring as many cases as possible in the Second Circuit. Former SEC Commissioner Joseph Grundfest, quoted in the *Wall Street Journal* of August 29, 2001, stated that 61% of the securities law complaints filed this year were filed in the Second Circuit. *See* Jerry Markon, *Ruling in Compaq Stock-Fraud Suit Could Affect Shareholder Litigation*, WALL ST. J., Aug. 29, 2001, at C1, C14. The longer this conflict goes unresolved, the greater its impact will be on securities lawsuits and on the courts that have to deal with them. Accordingly, certiorari should be granted.

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1. The *Ronconi* court also applied a higher substantive standard of scienter — intent or deliberate recklessness — in conflict with the standard applied by the Second Circuit in the decision below. *Compare Ronconi*, 253 F.3d at 429, *with In re Scholastic*, App. 23a ("knew or should have known").

I. The Second Circuit's Pleading Standards Are In Direct Conflict With The Statute And With Decisions Of Other Courts of Appeals Interpreting The Statutory Pleading Requirements, Creating Confusion In Other Circuits And Among District Courts

Congress intended the pleading standards of the PSLRA to "curb abuses."[2] Outside the Second Circuit, these statutory pleading standards are being enforced. In *Ronconi*, the Ninth Circuit stated that "[t]he heightened pleading requirements of the Private Securities Litigation Reform Act are an unusual deviation from the usually lenient requirements of federal rules pleading." *Ronconi v. Larkin*, 253 F.3d 423, 437 (9th Cir. 2001). In the Ninth Circuit, and other circuits, the complaint in this case would have been dismissed.

A. The Decisions of the Courts of Appeals Recognize the Fundamental Conflict with the Second Circuit on the Requirements of Sections (b)(1) and (b)(2)

Each of the legal rules adopted in the decision below is the subject of a conflict that is explicitly recognized by other courts of appeals. Section by section, the following pages are devoted primarily to the courts' own language on these issues.

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2. As the First Circuit stated:

> About all that can be said with confidence on that issue is that Congress agreed on the need to curb abuses, that it attempted to do so in the guise of what are articulated as procedural requirements, and that there was agreement on the words of the statute and on little else.

Greebel v. FTP Software, Inc., 194 F.3d 185, 192 (1st Cir. 1999).

1. **Are allegations based on "fraud by hindsight" enough to meet the requirement that a plaintiff plead facts specifying how and why each challenged statement was misleading when it was made?**

The Second Circuit held that Plaintiffs could meet their pleading burden as to the alleged misstatements by relying on the February 20 and subsequent announcements to infer fraud. In the Ninth Circuit, such pleading is grounds for dismissal. The Ninth Circuit recognizes that by demanding specific, contemporaneous facts from plaintiffs, Congress meant to prevent fraud by hindsight claims.

Second Circuit "As stated earlier, post-class period data may be relevant to determining what a defendant knew or should have known during the class period. And an inference, from the size of the special charge, that trade business in Goosebumps books declined throughout the third quarter, is not unreasonable." App. 17a (citations omitted).

Ninth Circuit "Congress enacted the PSLRA to put an end to the practice of pleading 'fraud by hindsight.' . . . We conclude that Brody's general allegations regarding negative internal reports and stock sales do not give rise to a strong inference of deliberate recklessness. This properly serves the PSLRA's purpose of establishing 'uniform and more stringent pleading requirements to curtail the filing of meritless lawsuits.' "

In re Silicon Graphics Inc. Sec. Litig., 183 F.3d 970, 988 (9th Cir. 1999) (quoting H.R. Conf. Rep. No. 104-369, at 41 (1995))

2. Does the requirement that plaintiffs plead "all facts supporting" allegations made on information and belief mean that plaintiffs must plead "all facts"?

The new statutory standard requires that for every alleged misstatement, the complaint must provide factual support showing fraud. If allegations are based on information and belief, the plaintiff must state with particularity all facts supporting that belief.

But the Second Circuit did not demand facts specifying each misstatement. The Second Circuit also did not require "all facts." Indeed, the Second Circuit allowed plaintiffs to use allegations based upon information and belief to support their other allegations, including their allegations of *scienter*.

The Second Circuit's tolerant pleading standard was dispositive. In the First, Sixth and Ninth Circuits, Plaintiffs' failure to specify the basis for their allegations would have been grounds for dismissal.

Second Circuit "Notwithstanding the use of the phrase 'all facts,' plaintiffs need not plead with particularity every single fact upon which they base their beliefs concerning the false or misleading nature of defendant's statements." App. 22a.

First Circuit	"[T]his court has required plaintiffs who bring their claims on information and belief to 'set forth the source of the information and the reasons for the belief.'" *Greebel,* 194 F.3d at 194 (quoting *Romani v. Shearson Lehman Hutton*, 929 F.2d 875, 878 (1st Cir. 1991)).
Sixth Circuit (*en banc*)	"The Act requires plaintiffs to 'specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which the belief is formed.' " *Helwig*, 251 F.3d at 550 (quoting 15 U.S.C. § 78u-4(b)(1)).
Ninth Circuit	"This paragraph is an insufficient basis for fraud allegations because it fails to state 'with particularity all facts on which [her] belief is formed.' This means that a plaintiff must provide, in great detail, all the relevant facts forming the basis of her belief. It is not sufficient for a plaintiff's pleadings to set forth a belief that certain unspecified sources will reveal, after appropriate discovery, facts that will validate her claim." *In re Silicon Graphics*, 183 F.3d at 985 (quoting 15 U.S.C. § 78u-4(b)(1)).

3. Is the proper standard for judging inferences of *scienter* whether they are "strong" or merely "not unreasonable"?

Congress required plaintiffs to plead facts supporting a strong inference of *scienter*. The Second Circuit has concluded that this did not change *its* pleading standards or *its* pre-PSLRA case law. Thus, in the Second Circuit a plaintiff may plead *scienter* by alleging a motive to commit fraud and an opportunity to do so, or by pleading "strong circumstantial evidence" of fraud.

As applied by the Second Circuit, both tests effectively permit plaintiffs to plead *scienter* with allegations that would not support a "strong inference" of fraud in other circuits. In this case the Second Circuit accepted any inferences as long as they were "not unreasonable", requiring only that the allegations permit an inference about what Scholastic "should have known." Holding plaintiffs to this lesser burden, the Second Circuit reinstated a complaint that would not have passed muster in other circuits.

Second Circuit "Accepting all of the allegations in the complaint as true and drawing all reasonable inferences in favor of plaintiffs, dismissal is proper 'only if it is clear that no relief *could* be granted under any set of facts that *could* be proved consistent with the allegations.' " App. 8a (emphasis added; citations omitted).

First Circuit "While under Rule 12(b)(6) all inferences must be drawn in plaintiffs' favor, inferences of scienter do not survive if they are merely reasonable, as is true when pleadings for

other causes of action are tested by motion to dismiss under Rule 12(b)(6). Rather, inferences of scienter survive a motion to dismiss only if they are both reasonable and '*strong*' inferences." *Greebel*, 194 F.3d at 195-96 (citation omitted).

Sixth Circuit (*en banc*)

"Rather, the 'strong inference' requirement means that plaintiffs are entitled *only to the most plausible of competing inferences*. *See* Black's Law Dictionary 1423 (6th ed. 1990) (defining "strong" as "cogent, powerful, forcible, forceful"). This represents a significant strengthening of the pre-PSLRA standard under Rule 12(b)(6), which gave the plaintiff 'the benefit of *all* reasonable inferences,' and contemplated dismissal 'only if it is clear that no relief could be granted under *any* set of facts that could be proved consistent with the allegations.' " *Helwig*, 251 F.3d at 553 (first emphasis added; citations omitted).

Ninth Circuit

"Because falsity and scienter in private securities fraud cases are generally strongly inferred from the same set of facts, we have incorporated the dual pleading requirements of 15 U.S.C. §§ 78u-4(b)(1) and (b)(2) into a single inquiry. In considering whether a private securities fraud complaint can survive dismissal under Rule 12(b)(6), we must determine whether 'particular facts in the complaint, taken as a whole, raise a strong inference that

> defendants intentionally or [with] 'deliberate recklessness' made false or misleading statements to investors.' Where pleadings are not sufficiently particularized or where, taken as a whole, they do not raise a 'strong inference' that misleading statements were knowingly or [with] deliberate recklessness made to investors, a private securities fraud complaint is properly dismissed under Rule 12(b)(6)." *Ronconi*, 253 F.3d at 429 (footnote omitted).

4. Does pleading "motive and opportunity" alone meet the *scienter* requirements of § (b)(2)?

Going beyond its willingness to accept lesser inferences of *scienter*, the Second Circuit also retained its alternative pre-PSLRA test for pleading *scienter*: pleading that the defendant had a motive and the opportunity to commit fraud. That standard was decisive as to Marchuk, where plaintiffs were able to plead *scienter* by alleging only that (i) he was an executive at Scholastic, and (2) he sold 80% of his Scholastic stock in late December and early January.

In contrast, other courts of appeals have held that the PSLRA rejected this standard, and that facts showing a "strong inference" of *scienter* require more than just a motive and the opportunity to commit fraud.[3] Indeed, in *Ronconi* the Ninth Circuit found,

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3. The Third Circuit's position is unclear. In its decision in *In re Advanta Corp. Securities Litigation*, 180 F.3d 525 (3d Cir. 1999), the Third Circuit stated that the PSLRA "establish[ed] a pleading standard approximately equal in stringency to that of the Second Circuit." *Id.* at 534. But the court went on to hold that "catch-all allegations that defendants stood to benefit from wrongdoing

(Cont'd)

based on a detailed contextual analysis, that plaintiffs had not alleged a strong inference of *scienter* by pleading insider sales by seven executives, including the General Counsel's sale of 98% of her stock. In the Ninth Circuit, this complaint would have been dismissed.

Second Circuit	"Plaintiffs can plead scienter by (a) alleging facts demonstrating that defendants had both the motive and an opportunity to commit fraud or (b) otherwise alleging facts to show strong circumstantial evidence of defendants' conscious misbehavior or recklessness." App. 19a.
First Circuit	"[M]erely pleading motive and opportunity, regardless of the strength of the inferences to be drawn of scienter, is not enough." *Greebel*, 194 F.3d at 197.
Sixth Circuit (*en banc*)	"We reaffirm that plaintiffs cannot simply plead 'motive and opportunity' as a mantra for recovery under the Reform Act. The Act requires plaintiffs to 'specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which the belief is formed.'" *Helwig*, 251 F.3d at 550 (quoting 15 U.S.C. § 78u-4(b)(1)).

(Cont'd)
and had the opportunity to implement a fraudulent scheme are no longer sufficient, because they do not state facts with particularity or give rise to a strong inference of scienter." *Id.* at 535.

Ninth Circuit "It follows that plaintiffs proceeding under the PSLRA can no longer aver intent in general terms of mere 'motive and opportunity' or 'recklessness,' but rather, must state specific facts indicating no less than a degree of recklessness that strongly suggests actual intent." *In re Silicon Graphics*, 183 F.3d at 979.

"Also, Debuono's trading [of 98% of her stock] supports only a weak inference, not a strong one, in light of what the other, equally knowledgeable insiders were doing." *Ronconi*, 253 F.3d at 436.

Eleventh Circuit "We conclude that the statutory language — 'required state of mind' — plainly does not refer to motive and opportunity, because motive and opportunity do not constitute a state of mind. Thus we conclude that the Reform Act did not codify the motive and opportunity analysis." *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1286 (11th Cir. 1999).

This case is thus fundamentally different from *Novak v. Kasaks*, 216 F.3d 300 (2d Cir.), *cert. denied*, 121 S. Ct. 567 (2000), where this Court denied certiorari. In *Novak* it was not clear what effect the pleading standards would have. Indeed, the Second Circuit remanded the case, stating: "On remand, we instruct the district court to: (a) permit the plaintiffs to replead; and (b) evaluate their pleadings anew in light of our interpretation of these requirements." *Id.* at 315. In this case, the Second Circuit held that the

"complaint is reinstated, and the case is remanded to the district court for further proceedings not inconsistent with this opinion." App. 27a.

The impact of the conflict on the present case is clear: the less stringent pleading standards made the difference between the complaint being dismissed with prejudice and Scholastic having to undergo expensive and disruptive discovery.

B. The Conflict Among the Courts of Appeals Has Crystalized; District Court Judges Are Forced to Perform a Choice of Law Analysis When Applying a Federal Statute Meant to Bring Uniformity to the Securities Laws

The conflict is not limited to the circuit courts. District courts in circuits without controlling circuit authority know that they must choose between the law of the Second Circuit and the law of some other circuit. *See, e.g., In re Baker Hughes Sec. Litig.*, 136 F. Supp. 2d 630, 638-41 (S.D. Tex. 2001) (reviewing split among circuits and split among district courts in the Fifth Circuit); *Lindelow v. Hill*, No. 00 C 3727, 2001 WL 830956, at *6 (N.D. Ill. July 20, 2001) (noting that majority of courts in Northern District of Illinois followed Second Circuit formulation for alleging scienter); *Sakhrani v. Brightpoint, Inc.*, No. IP99-0870-C-H/G, 2001 WL 395752, at *13 (S.D. Ind. Mar. 29, 2001) (noting split among courts of appeals); *Caprin v. Simon Transp. Serv.*, 112 F. Supp. 2d 1251, 1258-59 (D. Utah 2000) (reviewing split among courts of appeals and following "the higher pleading standard articulated by the Ninth and Sixth Circuits").

The full extent of the problem in district courts is highlighted in a recent study by Joseph A. Grundfest and A.C. Pritchard, *Statutes with Multiple Personality Disorder: The Value of Ambiguity in Statutory Design and Interpretation*, John M. Olin Center for Law & Economics, University of Michigan, Paper No. 01-006 (Aug. 23, 2001), *available at* http://www.law.umich.edu/centersandprograms/olin/papers.htm. Professors Grundfest and Pritchard analyzed 29 appellate decisions (including the decisions issued between May 31 and June 6), and 167 district court decisions that have dealt with the issue of pleading standards under the PSLRA. *Id.* at 47-50, 61-63. As to the appellate decisions they stated: "Seven different courts of appeal, applying identical rules of statutory construction to identical text and legislative history, have reached three distinct interpretations of the strong inference standard." *Id.* at 52. Those standards range from the Second Circuit, which is the most pro-plaintiff, to the Sixth Circuit's intermediate standard, to the Ninth Circuit's strict interpretation. *Id.*

The authors note that the Second Circuit has reversed the last four dismissals to reach it after *Novak*. *Id.* at 54. Comparing outcomes among the circuits, the authors note that the vast majority of plaintiffs' victories on appeal come from applying the Second Circuit standards, and note that "This pattern is consistent with the hypothesis that the standard does influence the outcome, and that plaintiffs do in fact fare better on appeal in circuits that apply the Second Circuit standard rather than any more rigorous formulation." *Id.* at 56.

But their most compelling analysis is of district court decisions. After applying a wide variety of statistical measures, the authors conclude that when district judges

choose among the various standards, "their conduct is, to a remarkable degree, statistically indistinguishable, from a 'coin-toss' model of judicial behavior." *Id.* at 127. Although the authors do not suggest that district judges are actually flipping coins to determine the law, they note that in the absence of controlling circuit precedent there is not a consistent interpretation of the statute even within a circuit. *Id.* at 128.

The authors conclude by noting that their findings "suggest that the questions presented by the 'strong inference' debate are ripe for Supreme Court review in order to resolve a split among the circuits and confusion in the district courts." *Id.* at 131. Petitioners agree.

CONCLUSION

The decision of the Second Circuit Court of Appeals in this case is in direct conflict with the decisions of the Courts of Appeals for the First, Sixth, Ninth and Eleventh Circuits on important issues of federal securities law. This case presents the opportunity for this Court to resolve the conflict. Accordingly, Petitioners respectfully submit that a writ of certiorari to the Second Circuit should be granted and that this case should be heard by the Supreme Court on the issues of law raised by this Petition: the proper interpretation of §§ 21D(b)(1) and (b)(2) of the Securities Exchange Act.

Respectfully submitted,

MICHAEL J. CHEPIGA
Counsel of Record
DAVID E. MASSENGILL
DAVID ELBAUM
SIMPSON THACHER & BARTLETT
425 Lexington Avenue
New York, NY 10017
(212) 455-2000

Of Counsel:

PROFESSOR ELLIOTT J. WEISS
CHARLES E. ARES PROFESSOR OF LAW
JAMES E. ROGERS COLLEGE OF LAW
UNIVERSITY OF ARIZONA
1200 East Speedway Boulevard
Tucson, AZ 85721
(520) 621-3578

Attorneys for Petitioners

APPENDIX

APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT DATED AND DECIDED JUNE 1, 2001

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

August Term, 2000

(Argued November 15, 2000 Decided JUN 1 2001)

Docket No. 00-7517

IN RE: SCHOLASTIC CORPORATION
SECURITIES LITIGATION

LAWRENCE B. HOLLIN, individually and
on behalf of all others similarly situated,

Plaintiff,

RICHARD TRUNCELLITO and THE CITY
OF PHILADELPHIA,

Appellants,

v.

SCHOLASTIC CORPORATION and
RAYMOND MARCHUK,

Defendants-Appellees,

RICHARD ROBINSON,

Defendant.

Appendix A

Before:

CARDAMONE, CALABRESI, *Circuit Judges*,
and HAIGHT*, *District Judge*.

* * *

CARDAMONE, *Circuit Judge*:

On this appeal we construe a complaint in a securities fraud case brought by stockholders against a book publisher and one of its officers. It is the book publisher's practice to count as income the proceeds of any book it sells to a retailer or distributor, while at the same time granting to such buyers a full right of return. The number of returns is therefore critical to profitability in the publishing business because when returns occur the publisher not only has unsold inventory back on its hands, but, also, income it has previously declared never materializes.

Plaintiffs allege that during the class period defendants knew returns had increased significantly, and that this negative corporate development later precipitated a large loss and a steep plunge in the company's publicly traded stock. The company is said to track book returns on a monthly and

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* Hon. Charles S. Haight, Jr., United States District Court Judge for the Southern District of New York, sitting by designation.

weekly basis, and to have daily information available to it from other sources as well. But despite such data establishing an adverse trend, the company announced publicly that its return rates were running at normal levels.

Defendants maintain, in effect, that there are no allegations in the complaint that would support proofs of either false statements or a fraudulent intent. To the contrary, we think plaintiffs sufficiently allege an unusual business model which, if proven, ignored alarmingly high returns that function as an obvious straw to show which way the wind was blowing in this book business. They may also be able to prove that the defendant officer, represented to stock analysts to be a key spokesperson, cashed in 80 percent of his stock while disseminating information that the company was not experiencing financial difficulties. For a spokesperson to cash in his own stock can in appropriate circumstances be like a ship's captain exiting into the safety of a lifeboat while assuring the passengers that all is well. A jury could find defendants liable for such behavior if its existence were supported by sufficient evidence. As such, plaintiffs in our view have survived the *pleading stage* of this securities fraud litigation.

BACKGROUND

Lawrence B. Hollin, individually and on behalf of all others similarly situated, began the instant class action securities fraud suit against defendant Scholastic Corporation, a book publishing company, and its officer Richard Robinson in the United States District Court for the Southern District of New York (Keenan, J.). The complaint

asserted claims pursuant to § 10(b) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. § 78j(b) (1994), Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5 (2000), and § 20(a) of the Exchange Act, 15 U.S.C. § 78t(a) (1994).[1] A consolidated amended complaint was filed August 13, 1997 and dismissed on December 15, 1998 following a Rule 12(b)(6) motion brought by defendants, *see In re Scholastic Corp. Sec. Litig.*, No. 99 Civ. 2447, 1998 WL 872422 (S.D.N.Y. Dec. 15, 1998), and the district court granted plaintiffs leave to amend.

On March 8, 1999 court-appointed lead plaintiffs Richard Truncellito and the City of Philadelphia filed a corrected second consolidated amended class action complaint. They named Scholastic and Raymond Marchuk, who serves as Scholastic's vice president for finance and investor relations, as defendants. The plaintiff class includes those persons who purchased Scholastic common stock during the class period and who sustained damages allegedly because defendants made materially false and misleading statements and concealed adverse facts regarding their publishing business, thereby causing plaintiffs to purchase the stock at artificially inflated prices.

Defendants in response filed another motion to dismiss under Rule 12(b)(6), arguing that plaintiffs failed to state a

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[1] We recognize that Congress amended §§ 10 and 20 through legislation passed at the end of 2000. *See* Consolidated Appropriations — FY 2001, Pub. L. No. 106-554, Appendix G — H.R. 5660, §§ 205(a)(3), 206(g), 303(d), (i) & (j), 114 Stat. 2763, 2763G-1, 2763G-62, 2763G-68, 2763G-90, 2763G-92 (2000). These changes have no bearing on the merits of this appeal.

claim and failed to plead fraud with particularity, as required under Federal Rule of Civil Procedure 9(b) and the Private Securities Litigation Reform Act (Securities Reform Act), Pub. L. No. 104-67, 109 Stat. 737 (1995). The district court granted the motion. *See In re Scholastic Corp. Sec. Litig.* (*Scholastic Corp.*), No. 99 Civ. 2447, 2000 WL 91939 (S.D.N.Y. Jan. 27, 2000).

On appeal, we examine the factual allegations set out in plaintiffs' second amended complaint in some detail, assuming them, as we must, to be true. *Novak v. Kasaks*, 216 F.3d 300, 305 (2d Cir.), *cert. denied*, 121 S. Ct. 567 (2000).

A. *Scholastic's Business and Its Operations Prior to the Class Period*

Plaintiffs' allegations reveal that Scholastic is a leading publisher and distributor of children's books, classroom and professional magazines, and other educational products, which it sells through retail distributors, book clubs, book fairs, classrooms and libraries. In the years leading up to 1996-1997, Scholastic's best-selling product was "Goosebumps," a series of "scary" children's books. Prior to December 1996, defendants had expanded Goosebumps distribution to mass merchandisers and other non-traditional retailers. This change in strategy was presented to the public as a significant positive development.

What the public did not know was that Scholastic shipped books to retailers and distributors with a full right of return. In so doing, Scholastic could, under generally

accepted accounting principles, record revenues upon shipment to the retailer so long as an adequate reserve provision existed for books that might be returned. In June 1996, Scholastic announced through a press release that it was adopting Statement of Accounting Standard 121, which requires a more frequent evaluation of inventory and a write-down when appropriate.

Prior to its change in distribution strategy, Scholastic boasted one of the lowest book return rates in the children's book publishing industry. On September 12, 1996 Merrill Lynch issued a report on Scholastic's return rates that incorporated statements made at a meeting with senior Scholastic officers that included defendant Marchuk. These officers represented that the company's return rate historically ran at 15 to 20 percent, as compared to 35 percent rates at other book publishers, Goosebumps books were being returned at even less than 20 percent, and while the expansion into the mass retail market could cause the return rate to rise, it would rise only "modestly." Scholastic officials added that "the issue of managing return exposure is one that gets considerable management attention." No one at Scholastic corrected this report when it appeared.

First quarter results, ending August 31, 1996, recorded a loss worse than had been experienced in the same quarter the previous year. Nevertheless, on September 19, 1996 Merrill Lynch issued another report derived from statements by company officials that Scholastic's "return rates remain among the lowest in the industry at less than 20%, which might suggest that Goosebumps has been somewhat underdistributed."

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B. *What Allegedly Occurred During the Class Period*

The class period in this lawsuit begins on December 10, 1996, the day Scholastic issued a press release announcing a net income for the second quarter of the 1997 fiscal year, which ended November 30, 1996. The income represented a 24 percent increase over the comparable period for the prior year. The class period ends on February 20, 1997, when Scholastic issued another press release announcing an expected third quarter loss of 70 to 80 cents per share. Prior to this release, Scholastic had expressed "comfort" with income estimates of 64 to 73 cents per share. Scholastic's news of an expected loss also contrasted with estimates by stock analysts that Scholastic would realize a net income of approximately 69 cents per share. The February 20 press release stated further that Scholastic would take a $13 million pre-tax special charge consisting of a reserve for anticipated additional book returns. The next day, Scholastic stock fell 40 percent or $24.75 per share. Another $11 million special charge for book returns was taken in the following quarter. Industry analysts thereafter questioned the credibility of Scholastic management with respect to what officials knew and how long they had known it before Scholastic made the third quarter announcement.

What happened between the December 10, 1996 and February 20, 1997 press releases forms the basis for plaintiffs' lawsuit. Defendants are alleged to have disseminated false information, withheld damaging truthful information and failed to update prior public statements that had become materially misleading. In addition, defendant

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Marchuk is alleged to have sold a large percentage of his Scholastic stock within a week's time (starting at the end of 1996), and plaintiffs further claim that Marchuk influenced Scholastic's decision to disseminate false and misleading statements in ways that would cause him to be liable as a "controlling person" as that term is defined in § 20(a) of the Exchange Act.

DISCUSSION

The grant of a motion to dismiss pursuant to Federal Rule of Civil Procedure 12(b)(6) is reviewed on appeal *de novo*. *See Rothman v. Gregor*, 220 F.3d 81, 88 (2d Cir. 2000). Accepting all of the allegations in the complaint as true and drawing all reasonable inferences in favor of plaintiffs, *see Press v. Chem. Inv. Servs. Corp.*, 166 F.3d 529, 534 (2d Cir. 1999), dismissal is proper "only if it is clear that no relief could be granted under any set of facts that could be proved consistent with the allegations," *Hishon v. King & Spalding*, 467 U.S. 69, 73 (1984). To decide whether plaintiffs have sufficiently pled facts in support of their claims, we look to the elements of a securities fraud and a "controlling-person" liability claim.

I Section 10(b) Securities Fraud Claim

For a plaintiff to state a viable cause of action for securities fraud under § 10(b), 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5(b), the complaint must allege that in connection with the purchase or sale of securities, defendant, acting with scienter, either made a false material representation or omitted to disclose material information

so that plaintiff — acting in reliance either on defendant's false representation or its failure to disclose material information — suffered injury and damages. *See Rothman*, 220 F.3d at 89. The Exchange Act, as amended by the Securities Reform Act also requires that "the complaint shall specify each statement alleged to have been misleading, [and] the reason or reasons why the statement is misleading." 15 U.S.C. § 78u-4(b)(1) (1994 & Supp. V 1999).

Specificity is also required by the Federal Rules of Civil Procedure, which provide that "[i]n all averments of fraud . . . the circumstances constituting fraud . . . shall be stated with particularity." Fed. R. Civ. P. 9(b). The complaint must identify the statements plaintiff asserts were fraudulent and why, in plaintiff's view, they were fraudulent, specifying who made them, and where and when they were made. *Mills v. Polar Molecular Corp.*, 12 F.3d 1170, 1175 (2d Cir. 1993).

A. *False Material Representation or Failure to Disclose Material Information*

In their complaint, plaintiffs identify specific statements or sets of statements believed to be materially false and misleading. The first is the press release issued by Scholastic on December 10, 1996, announcing its net income for the second quarter of the 1996-97 fiscal year.

The second set of statements arises out of a conference call with analysts the day after the press release was issued, in which defendant Marchuk is alleged to have participated. Merrill Lynch issued a report on December 12 stating that defendants emphasized that the "front list" of newer

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Goosebumps titles demonstrated strong growth and that any flattening of trade revenues was due to older titles. Although Merrill Lynch also reported defendants as saying the quarterly retail sales results were distorted and had suffered in comparison to the second quarter for the previous year, Deutsche Morgan Grenfell reported on December 13, 1996 that defendants continued to maintain that a 20 percent growth in Goosebumps retail sales was reasonable. Defendants received copies of these reports and made no corrections.

Third, plaintiffs point to the prospectus supplement issued by Scholastic on December 18, 1996 in connection with its sale of $125 million in notes, in which the company reported second quarter results and stated that "[t]rade sales remained constant from the prior year's strong second quarter performance." Profitable second quarter results were also reported in Scholastic's Form 10-Q filed on January 14, 1997.

Merrill Lynch issued another report on January 31, 1997, again based on discussions with senior Scholastic officials including Marchuk. These officials said no surge in book returns had occurred, which Merrill Lynch considered important since it viewed higher-than-expected returns as a significant stock risk after Scholastic initiated mass market distribution. Merrill Lynch raised its rating on Scholastic stock from neutral to accumulate. That recommendation caused Scholastic's stock to rise by $1.50 per share.

Following this report, Merrill Lynch contacted Scholastic in early February to inquire about return rates. Defendant maintained that returns were at "normal" levels,

previously represented to be between 15 and 20 percent. Less than three weeks later, Scholastic issued its February 20 press release announcing expected losses for the third quarter.

B. *Trends Adequately Alleged*

Pursuant to 17 C.F.R. § 229.303(2000), promulgated by the Securities and Exchange Commission, defendants were required to disclose on Form 10-Q any known trends that would have or were reasonably likely to have a material impact on revenues. The trial court found the complaint had inadequately pleaded the existence of such trends and therefore found it failed to identify false or misleading statements. *Scholastic Corp.*, 2000 WL 91939, at *9-11. We think plaintiffs were held to a more stringent standard than the law requires and that the trend in declining sales and increasing returns is adequately alleged.

1. *Decline in Sales.* The complaint specifically sets out the distributors through which Goosebumps books were sold, and alleges declines in sales as of specific dates, some in terms of percentage and others in terms of quantity. Such information covers over two-thirds of Scholastic's trade business in Goosebumps.

For example, according to the complaint, Advanced Marketing Services Incorporated (AMS) represents 15 percent of Goosebumps sales. It was selling 20,000 sets of Goosebumps per week in June 1995, but only 10,000 sets per week in the fall of 1996. It downloads point-of-sale data (POS data) into its computers on a daily basis and permits Scholastic to download that same information.

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Ingram Distribution Group, Inc. which accounts for 50 percent of the Goosebumps trade, is said to have experienced a "significant decrease" in Goosebumps sales in the fall of 1996. Its orders dropped from 25,000 copies per title in September 1996 to 12,000 per title in January and February 1997. According to a senior manager at Ingram, this decline in a series was the steepest he had seen in his 15 years of experience in the book business. Ingram transmitted this information to Scholastic electronically and also collected POS data that was available to Scholastic.

Further, trade sales of Goosebumps books through Aramark Corporation, a book distributor that sells to mass retailers Target, Walmart and Kmart, allegedly dropped 50 percent between September 1995 and the fall of 1996. Target tracked Goosebumps sales on a weekly basis and sent its reports to the sales department at Scholastic.

The complaint similarly states that Caldor Corporation sold 6,000 to 7,000 books per week in September 1995, but only 3,000 books per week in September 1996. Its retail sales dropped further to 1,800 books per week in January 1997. Scholastic is said to have known of these trends both because Caldor's orders for Goosebumps books decreased, and because Caldor tracked daily sales figures and made them available to Scholastic.

Plaintiffs allege that Scholastic not only had access to POS data, but also reviewed it. Scholastic "thus knew how a substantial percentage of its Goosebumps books were selling in the trade market on at least a weekly basis, and also, therefore, the growing number of unsold Goosebumps

books distributors and retailers had in inventory that were subject to full return."

2. *Increase in Returns.* Again, according to plaintiffs, the information on Goosebumps books returned each day to Scholastic's warehouse in Jefferson City, Missouri — the warehouse through which the company processes and fulfills most orders for trade distribution — are entered into an "AS400" computer at the warehouse. That information, in turn, is transferred each night to Scholastic's corporate offices. By Christmas 1996, Greg Wong, a Scholastic employee responsible for evaluating inventory levels in Scholastic's New York office, allegedly told the inventory manager at the Jefferson City warehouse that the situation for Goosebumps had taken a turn for the worse and returns would continue to mount because many titles were overstocked and overbought.

Plaintiffs further allege defendant Marchuk monitored internal data. Along with Leslie Lista, Scholastic's comptroller, he compiled and distributed a "Director's Book" each month to all members of the board. The Director's Book analyzed trade sales data and provided commentary on sales trends. Moreover, trade sales figures were sent to the head of each Scholastic division on a weekly basis, and the sales department received weekly trade book sales reports, title by title, from the company's Jefferson City warehouse.

With respect to outside information, Toys R Us returned "an unusually high amount" of Goosebumps books in December 1996, after advising Scholastic earlier in the month that their increasingly scary content was resulting in a

"significant" growth in returns. Returns from distributor Levy Home Entertainment "began to rise to unprecedented levels" in November and December 1996. Its returns in January 1997 equaled 50 to 70 percent of October and November 1996 sales. By January 1997 the amount of returned books consigned to the employee bookstore had grown to such an extent that little room existed to walk into the store.

The complaint asserts that ultimately, returns for January 1997 amounted to about $4 or $5 million, an increase of 150 percent over January 1996 levels. The complaint also alleges that this information was known to defendants in early February, prior to the time when defendants allegedly assured Merrill Lynch that returns remained at normal levels.

3. *Pleadings Sufficiently Specific.* The district court viewed certain allegations regarding December 1996 book returns as "too vague." *Scholastic Corp.*, 2000 WL 91939, at *11. Yet, a reasonable inference can be drawn that if Goosebumps sales through AMS and Aramark declined throughout the fall of 1996, and sales through Ingram and Caldor dropped by about 50 percent from September 1996 through January 1997, then a decline was also experienced through the month of December 1996.

With respect to sales, the district court faulted plaintiffs for employing pre-class period information in their pleadings, and for not relying instead on sales data from the relevant period, that is, from December 1996 — data that it said would have shown that declining sales were made known to defendants. *Scholastic Corp.*, 2000 WL 91939, at *10.

Pre-class data is relevant in this case, however, to establish that at the start of the class period, defendants had a basis for knowing increased Goosebumps sales were unlikely in the third quarter due to marked decreased sales experienced in the second quarter. Just as our cases have relied on post-class period data to confirm what a defendant should have known during the class period, *see, e.g.*, *Rothman*, 220 F.3d at 92; *Novak*, 216 F.3d at 312-13, so the same logic applies here.

Any information that sheds light on whether class period statements were false or materially misleading is relevant. Even with the heightened pleading standard under Rule 9(b) and the Securities Reform Act we do not require the pleading of detailed evidentiary matter in securities litigation. *See Ross v. A.H. Robins Co.*, 607 F.2d 545, 557 n.20 (2d Cir. 1979). Moreover, the district court failed to take into account the alleged facts that Scholastic reviewed POS data made available by AMS and Caldor on a daily basis, by Target on a weekly basis and by Ingram to learn returns would be on the rise.

Plaintiffs also include allegations as to company-generated statistics. In *San Leandro Emergency Medical Group Profit Sharing Plan v. Philip Morris Companies*, 75 F.3d 801, 812 (2d Cir. 1996), we held that an "unsupported general claim of the existence of confidential company sales reports that revealed [a] larger decline in sales is insufficient to survive a motion to dismiss." We then cited cases from other circuits stating that a plaintiff needs to specify the internal reports, who prepared them and when, how firm the numbers were or which company officers reviewed them.

Id. at 812-13 (citing *Serabian v. Amoskeag Bank Shares, Inc.*, 24 F.3d 357, 365 (1st Cir. 1994) (specific identification of internal report held sufficient), *superseded by statute on other grounds, see Greebel v. FTP Software, Inc.*, 194 F.3d 185 (1st Cir. 1999), and *Arazie v. Mullane*, 2 F.3d 1456, 1467 (7th Cir. 1993) (failure to give specific identification held insufficient)). Plaintiffs have satisfied this standard by specifying who prepared internal company reports, how frequently the reports were prepared and who reviewed them. We further observe that the complaint gives additional indications as to the nature of the reports, because the allegations are immediately preceded and followed by figures from retailers to show sales were declining. In *San Leandro*, we noted that plaintiffs had simply made an unsupported general claim that confidential company sales reports existed to contradict public statements. *See* 75 F.3d at 812. Plaintiffs here instead have gone beyond the bare pleadings found in *San Leandro*, and have met the criteria identified in *Arazie* and *Serabian*.

Moreover, always according to the amended complaint, Scholastic engaged in aggressive sales practices during the second and third quarters of its 1996-97 fiscal year. This, if proven, would furnish additional support for the proposition that company officials were aware of declining sales and increasing returns. These aggressive tactics, allegedly, included: offering excessive discounts beyond the company's normal practices for the purchase of additional books; altering its return policy to delay the return of Goosebumps books; encouraging distributors to keep unsold books rather than return them; and assuring distributors that Scholastic would extend its billing period for 90 days — and sometimes

for as long as six months. Scholastic gave distributors free advertising dollars, subsidized freight costs when books were finally returned, and repackaged Goosebumps books and merchandise at no cost. In this way, plaintiffs claim, defendant staved off or delayed disclosure of the huge amount of book returns to its inventory and delayed having to set up adequate reserves for the income it had reported, but due to huge returns would never receive.

The $13 million pre-tax special charge taken by Scholastic in February 1997 lends yet more support to the notion that defendants had knowledge of increasing returns. As stated earlier, post-class period data may be relevant to determining what a defendant knew or should have known during the class period. *See Rothman*, 220 F.3d at 92; *Novak*, 216 F.3d at 312-13. And an inference, from the size of the special charge, that trade business in Goosebumps books declined throughout the third quarter, is not unreasonable. Further, since January 1997 returns amounted to about $4 or $5 million, the claim that Scholastic took a charge almost three times that amount would support proofs that returns did not pile up only in that month, but throughout the class period.

Consequently, we conclude that plaintiffs pleaded with sufficient particularity facts necessary to show a downward trend with respect to Goosebumps' profitability. The facts alleged are sufficient to establish a trend even in the face of the admittedly cyclical nature of Scholastic's business. Scholastic explained in the September 1996 press release that its first quarter loss was not uncommon because of higher expenses not offset by greater revenues in the summer

months. But, with the second and third quarters covering months when revenues should have increased, plaintiffs have alleged enough to permit proofs that Scholastic should have been alerted, by decreased sales and increased returns, to negative business results in the relevant time frame.

Further throwing doubt on its retail sales being subject to the cyclical nature of the school calendar, Scholastic's CEO said in a press release that Goosebumps books "continued to sell well in trade" even during the first quarter. If the books were selling well during typically slower summer months, and data began to show the books were not selling well during Scholastic's usually busier fall and winter months, plaintiffs could show defendants knew they had a problem that would affect the price of their stock and recklessly failed to acknowledge it at the time.

We conclude therefore that the facts alleged are sufficiently detailed to allow the plaintiffs to present proofs that the defendants knew, despite the fact that their business was cyclical, of a material downward secular trend. It may be that at summary judgment, or even at trial, the defendants demonstrate so profoundly cyclical a business and a strong enough link between normal cycles and the negative information available to them, that a reasonable jury could not find that they violated the securities laws. But any speculation to that effect is inappropriate at the pleadings stage.

C. *Scienter*

The Securities Reform Act imposes on plaintiffs the obligation to "state with particularity facts giving rise to a

strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2); *see also Novak*, 216 F.3d at 311 (reaffirming that Second Circuit case law remains the standard after passage of the Act). Plaintiffs can plead scienter by (a) alleging facts demonstrating that defendants had both the motive and an opportunity to commit fraud or (b) otherwise alleging facts to show strong circumstantial evidence of defendants' conscious misbehavior or recklessness. *See Novak*, 216 F.3d at 307.

1. *Motive and Opportunity*

Motive is the stimulus that causes a person or entity to act or to fail to act. Such stimulus ordinarily anticipates a concrete benefit defendant would realize by his conduct. Plaintiffs allege that defendant Marchuk was motivated to withhold damaging information about Goosebumps sales and returns so that he could sell his Scholastic stock at a higher price.

With respect to opportunity, Marchuk as an officer of Scholastic had access to insider information and thus had an opportunity to commit fraudulent acts. Our focus therefore rests on whether any motive existed for such conduct.

Plaintiffs' complaint alleges that Marchuk realized over $1.25 million in gross proceeds from the sale of his stock in defendant Scholastic during the class period. Marchuk sold a total of 19,400 shares — approximately 80 percent of his holdings of Scholastic stock — through trades on December 31, 1996 and January 2, 3, and 7, 1997. Plaintiffs claim that prior to these sales, he had not sold a single share of company stock since April 11, 1995.

The motive and opportunity element is generally met when corporate insiders misrepresent material facts to keep the price of stock high while selling their own shares at a profit. *See Novak*, 216 F.3d at 307-08. "Unusual" insider sales at the time of the alleged withholding of negative corporate news may permit an inference of bad faith and scienter. *See Acito v. IMCERA Group, Inc.*, 47 F.3d 47, 54 (2d Cir. 1995). Factors considered in determining whether insider trading activity is unusual include the amount of profit from the sales, the portion of stockholdings sold, the change in volume of insider sales, and the number of insiders selling. *See Rothman*, 220 F.3d at 94.

In *San Leandro*, 75 F.3d at 813-14, we said that a sale of stock by only one company executive netting over $2 million in profit did not give rise to a strong inference of fraudulent intent. In *Rothman*, 220 F.3d at 94, we held that an alleged $1.6 million profit on stock sales was not unusual. In *Acito*, 47 F.3d at 54, stock sales by one officer that amounted to less than 11 percent of his holdings also failed to qualify as "unusual."

But none of these cases established a *per se* rule that the sale by one officer of corporate stock for a relatively small sum can never amount to unusual trading. Rather, each case was decided on its own facts. For example, in both *San Leandro* and *Acito*, multiple individual defendants were named. We found in each case that the failure of other defendants to sell their stock undermined the plaintiffs' theories that negative information was withheld to obtain a higher sell price. *See San Leandro*, 75 F.3d at 814; *Acito*, 47 F.3d at 54. The second amended complaint in the present

case, however, names only Marchuk as an individual defendant. Consequently, whether other Scholastic officials sold their stock prior to the February 20, 1997 press release is not only unknown, but, as to Marchuk's possible liability, is also irrelevant, since in that regard motive is considered with respect to Marchuk alone.

As to the amount of the sales, *Rothman* and *San Leandro* make clear that $1.25 million standing alone may not be unusual. Yet dollar amount cannot be considered in isolation. Rather the percentage of stock holdings sold may be indicative of unusual trading. To illustrate, in *Rothman*, 220 F.3d at 94, a second defendant sold shares for a $20 million return. Despite this large amount, we did not consider it evidence of unusual trading because the percentage of shares sold in relation to the number held was small. *Id.* at 95.

In contrast, Marchuk is alleged to have sold 80 percent of his holdings within a matter of days for a not insignificant profit, after having sold no Scholastic stock since 1995. Although defendants contest this information, whether plaintiffs can prove their allegations is not to be resolved on a Rule 12(b)(6) motion. Therefore, in the context of this appeal, plaintiffs have adequately alleged motive and opportunity on Marchuk's part for concealing facts that ultimately caused the price of Scholastic's stock to drop precipitously.

Marchuk counters that despite the sale of his stock, the alleged fraudulent and misleading statements attributable to Scholastic have not been properly made attributable to him. He notes the complaint pleads that he was involved in disseminating such statements only "upon information and

belief." The Securities Reform Act provides that "if an allegation regarding [a] statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1). Notwithstanding the use of the phrase "all facts," plaintiffs need not plead with particularity every single fact upon which they base their beliefs concerning the false or misleading nature of defendant's statements, but instead are required only to plead with particularity sufficient facts to justify those beliefs. *See Novak*, 216 F.3d at 313-14. Contrary to Marchuk's contentions, plaintiffs have met this standard.

The complaint alleges that Marchuk was vice president for finance and investor relations, and therefore in a position both to access confidential information and to control the extent to which it was released to the public. *Cf. San Leandro*, 75 F.3d at 814 n.14 (observing that in addition to the sale of stock by only one defendant, "plaintiffs have alleged no facts suggesting that [this defendant] acting alone had the opportunity to manipulate [the company's] plans for his own advantage"). Assuming plaintiffs' allegations to be true, Marchuk was primarily responsible for Scholastic's communications with investors and industry analysts. He was involved in the drafting, producing, reviewing and/or disseminating of the false and misleading statements issued by Scholastic during the class period. Marchuk had access to internal corporate documents and reports relating to trade sales and return data, conversed with other officers and employees and attended management and committee meetings. He helped prepare the Director's Books analyzing data and commenting on sales trends.

Appendix A

These alleged facts are detailed enough to justify plaintiffs' belief that Marchuk was one of the senior officials involved in conversations with market analysts such as Merrill Lynch. As such, Marchuk would also have been in a position to know Scholastic's sales/return data and evaluate whether statements disseminated to the public accurately reflected such information.

2. *Conscious Misbehavior and Recklessness*

Plaintiffs' complaint adequately pleads scienter in its allegations concerning conscious misbehavior and recklessness on the part of Scholastic. To qualify as reckless conduct, defendants' conduct must have been "highly unreasonable" and "an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it." *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47 (2d Cir. 1978). Where the complaint alleges that defendants knew facts or had access to non-public information contradicting their public statements, recklessness is adequately pled for defendants who knew or should have known they were misrepresenting material facts with respect to the corporate business. *Novak*, 216 F.3d at 308. Plaintiffs claim defendants knew or were reckless in not knowing from information provided by internal monitoring and access to trade sales data that sales of Goosebumps books were declining and returns were increasing.

We recognize Scholastic was required under the law to disclose only material information. Information is material

if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available." *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988). The complaint indicates the information as to increasing returns was important because Merrill Lynch boosted its rating of Scholastic stock in January 1997 based upon representations from the company that no surge in book returns had occurred. The sharp criticism from industry analysts after Scholastic's February 20 press release further indicates the weight given to information pertaining to Goosebumps sales and returns.

As to whether plaintiffs adequately pled an inference of reckless intent, we find they did. Our discussion in Sections IA and B illustrates that the second amended complaint contains detailed allegations as to what defendants knew on a daily, weekly and monthly basis about the retail trade of Goosebumps books, while at the same time making public statements that painted a different picture. Defendants publicly represented that returns were not increasing and failed to adjust revenues despite their knowledge of rapidly rising returns; these actions, if proven, are consistent with recklessness. *See Rothman*, 220 F.3d at 90-91.

In this respect, the most egregious allegations involve Scholastic's response to inquiries from Merrill Lynch in early February 1997. At this point, even disregarding the information ostensibly received from computer runs, Scholastic knew the return rate for January 1997 had increased 150 percent from the year before. Yet by telling Merrill Lynch that return rates remained at normal levels of 20 percent, defendants acted in ways that could be found to be reckless.

Appendix A

Recklessness may also be shown based on the allegations that defendants learned from Toys R Us in early December 1996 that the newer Goosebumps books were too "scary" and hence were being returned. Defendants allegedly had represented to industry analysts at the time that more recent Goosebumps titles were doing well in the trade. Moreover, the combined total of $24 million in special charges during the third and fourth quarters undermines, at the pleading stage, the argument that defendants were unaware of the sharp increase in Goosebumps returns until shortly before Scholastic's February 20, 1997 press release. *See Rothman*, 220 F.3d at 92 (finding that the magnitude of defendant's post-class period write-off, together with the allegations of poor sales, constituted sufficient pleadings as to recklessness).

Finally, defendants' asserted actions contrary to expressed policy and prior practice can form the basis for proof of recklessness. Although Scholastic had adopted Statement of Accounting Standard 121, several months passed from September to February before a special pre-tax charge was taken to account for returns. Despite public statements that considerable management attention was given to monitoring returns, Scholastic issued no warnings or corrections after seeing first quarter sales suffer in comparison to the previous year and after revealing to Merrill Lynch in December that second quarter sales had suffered in similar fashion. *See Rothman*, 220 F.3d at 91 (describing a "reckless failure to follow an announced policy"); *Novak*, 216 F.3d at 311 (describing defendants who "knowingly sanctioned procedures that violated the Company's own markdown policy").

Appendix A

II Section 20(a) "Controlling-Person" Liability Claim

The district court also dismissed plaintiffs' § 20(a) claim because it concluded that the primary violation asserted was not adequately pled. Section 20 provides

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78t(a).

"Controlling-person liability" is a separate inquiry from that of primary liability and provides an alternative basis of culpability. *See SEC v. Mgmt. Dynamics, Inc.*, 515 F.2d 801, 812 (2d Cir. 1975). A plaintiff may allege a primary § 10(b) violation by a person controlled by the defendant, and culpable participation by the defendant in the perpetration of the fraud. *See SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1472 (2d Cir. 1996).

The district court dismissed plaintiffs' § 20(a) claim for failure to plead a primary § 10(b) violation. *Scholastic Corp.*, 2000 WL 91939, at *14. Since on appeal defendants offer

no basis for dismissing the secondary liability claim if we reverse the dismissal of the securities fraud causes of action, we hereby reinstate it.

CONCLUSION

Accordingly, for the reasons stated the judgment appealed from is reversed, plaintiffs' complaint is reinstated, and the case is remanded to the district court for further proceedings not inconsistent with this opinion.

APPENDIX B — MEMORANDUM OPINION AND ORDER OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK DATED JANUARY 26, 2000 AND FILED JANUARY 27, 2000

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

97 Civ. 2447 (JFK)

In re Scholastic Corporation Securities Litigation

This Order Relates To:

All Actions

MEMORANDUM OPINION and ORDER

* * *

JOHN F. KEENAN, United States District Judge:

Plaintiffs instituted this class action suit against Defendants on April 7, 1997, alleging violations of Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. § 78j(b), Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, and Section 20(a) of the 1934 Act, 15 U.S.C. § 78t(a). Plaintiffs filed a Consolidated Amended Complaint (the "First Amended Complaint") on August 13, 1997. In an Opinion dated December 14, 1998, I dismissed the First Amended Complaint for failure to plead fraud with sufficient particularity, pursuant to Fed. R. Civ. P. 9(b). *See In re Scholastic Corp. Sec. Litig.* ("*Scholastic I*"),

1998 WL 872422 (S.D.N.Y. Dec. 15, 1998). Plaintiffs were granted leave to amend and re-file the complaint, which they did on February 16, 1999. Defendants now move to dismiss the Second Consolidated Amended Class Action Complaint (the "Second Amended Complaint") for failure to state a claim upon which relief can be granted, pursuant to Fed. R. Civ. P. 12(b), and for failure to plead fraud with sufficient particularity, pursuant to Fed. R. Civ. P. 9(b). Because the Second Amended Complaint suffers from the same deficiencies as the First Amended Complaint, the motion to dismiss is granted and the Second Amended Complaint is dismissed with prejudice.

Background

The facts concerning Scholastic Corporation ("Scholastic"), its financial history, and the events that prompted the filing of this lawsuit are set forth in *Scholastic I*, *see* 1998 WL 872422, *1 – *7, familiarity with which is assumed. As a result, the Court will review only the facts specifically relevant to the instant motion to dismiss. The Second Amended Complaint alleges the following facts, which the Court presumes to be true for purposes of this motion.

Plaintiffs brought this class action on behalf of all persons who purchased the common stock of Defendant Scholastic Corporation ("Scholastic") between December 10, 1996, and February 20, 1997 (the "Class Period"). Defendant Ray Marchuk, Scholastic's Vice President for Financial and Investor Relations, was responsible for Scholastic's communications with investors and industry analysts. Plaintiffs claim that Scholastic and Marchuk issued false and

misleading statements during the Class Period in violation of § 10(b) and Rule 10b-5 which artificially inflated Scholastic's stock price and induced Plaintiffs to purchase Scholastic stock while Defendant Marchuk sold a significant portion of his own shares of Scholastic stock at inflated prices. Claims are also asserted against Defendant Marchuk, as a "controlling person" under § 20(a).

As discussed in *Scholastic I*, Scholastic's most successful product in recent years has been a series of books written by R.L. Stine known as the "Goosebumps" series. Goosebumps sales represented approximately 15% of Scholastic's gross revenues in the 1996 fiscal year. *See* Second Am. Compl. ¶ 28. Although Scholastic traditionally marketed its books through schools and specialty stores, prior to the Class Period, Scholastic expanded its distribution of Goosebumps to mass merchandisers and retailers, including Walmart, Caldor and various "price clubs." *See id.* ¶ 29. Scholastic ships books to retailers and distributors with a full right of return. Pursuant to Generally Accepted Accounting Principles ("GAAP"), a company can recognize a sale and record revenues on shipments to the retailer as long as there is an adequate reserve provision for books which may be returned. *See id.* ¶ 30. Accordingly, Scholastic fully recognizes revenue upon shipment of books to retailers and carries a reserve against future returns. If reserves are insufficient to cover returns, Scholastic is required to deduct an amount directly from income that will cover anticipated returns. *See id.* Historically, Scholastic had one of the lowest book return rates in the industry, ranging from 15-20% where rates as high as 35% were not uncommon. *See id.* ¶ 34.

Appendix B

A. September 1996 Reports and Press Releases

On September 12, 1996, Merrill Lynch issued a report on Scholastic based on a meeting with Scholastic senior officers, including, upon information and belief, Defendant Marchuk. *See id.* ¶ 34. The report provided that:

> Above-average retail returns have plagued many publishers distributing to retailers recently due, in large part, to retailer consolidations. Although publisher return rates in the 35% range are not all that uncommon, [Scholastic] continues to maintain among the lowest (if not the lowest) return rates in the industry at 15-20%. In our view, the risk of higher returns rises with the longer print runs necessitated by the popularity of Goosebumps. [Scholastic] management indicated that the return rate on Goosebumps is currently tracking at less than 20%, and the issue of managing return exposure is one that gets considerable management attention. Over time, management expects Goosebumps' return rate to rise to "modestly" above 20% as management attempts to achieve broader distribution.

See id.; Even Aff., Ex. 2, at *2.

Scholastic issued a press release on September 17, 1996 announcing its results for the first quarter of fiscal 1997, the period ending August 31, 1996, reporting a net loss of $14 million, or $.88 per share, compared to a net loss of $9.8 million, or $.62 per share in the same period in the

previous year. *See id.* ¶ 35. The press release noted that Scholastic's first fiscal quarter "historically produces an operating loss due to higher expenses without accompanying revenues during the summer months" and quoted Scholastic's CEO as stating that the Goosebumps book series "continued to sell well in trade." *See id.* Merrill Lynch issued another report on September 19, 1996, also based on information provided by Scholastic senior officers, which reported that:

> [Scholastic] has recently been expanding the distribution of Goosebumps distribution [sic] to mass merchandisers and other non-traditional retailers to increase the number of units in the market. Although we believe that this strategy will result in modestly higher return rates, [Scholastic's] return rates remain among the lowest in the industry at less than 20% which might suggest that Goosebumps has been somewhat underdistributed.

See id. ¶ 36; Even Aff., Ex. 4, * 2. Defendants did not object to any of the statements contained in the report. *See* Second Am. Compl. ¶ 36.

B. Scholastic's knowledge of declining trade sales and increasing book returns

Plaintiffs claim that Scholastic had knowledge that trade sales of Goosebumps were in decline and book return rates on the rise prior to and during the Class Period. Plaintiffs claim that Scholastic had knowledge pursuant to its internal monitoring of trade sales and book returns and from access to Goosebumps sales figures from Scholastic distributors.

Appendix B

1. Internal monitoring

Plaintiffs allege the following regarding Scholastic's internal monitoring of trade sales, which the Court notes are the same allegations that Plaintiffs included in their First Amended Complaint:

Defendant Marchuk, along with Scholastic's Comptroller, compiled and distributed to the Board of Directors on a monthly basis a "Director's Book" which analyzed the trade sales figures obtained from distributors and retailers and provided commentary on sales trends. Trade sales figures were also sent to the head of each Scholastic division on a weekly basis. In addition, the Sales Department received trade book sales reports, title by title, on a weekly basis from Scholastic's Jefferson City, Missouri warehouse — the warehouse through which Scholastic processes and fulfills most orders for trade distribution. *See* Second Am. Compl. ¶ 39.

2. Access to Goosebumps sales figures from Scholastic distributors

In the Second Amended Complaint, Plaintiffs allege, as they did in the First Amended Complaint, that Scholastic had access to the following Goosebumps sales figures from Scholastic distributors:

1. Advanced Marketing Services Incorporated ("AMS"), a distributor that sells Goosebumps to warehouse outlets and represents 15% of the Goosebumps trade sales market, downloads point-of-sale data ("POS data"), which includes

sales and inventory figures, into its computers on a daily basis and Scholastic is permitted to download that information. *See id.* ¶ 38(a). AMS was selling 20,000 sets of Goosebumps, with four books in a set, per week in June 1995 but only 10,000 sets per week in the fall of 1996 — a 50% drop. *See id.* ¶41.

2. Ingram Distribution Group, Inc., which accounts for approximately 50% of the Goosebumps trade market, also collects POS data which is available to Scholastic. *See id.* ¶ 38(c). Ingram experienced a "significant decrease" in Goosebumps sales in the fall of 1996. *See id.* ¶ 41.

3. The Caldor Corporation, a retailer which accounts for approximately 1% of the Goosebumps trade sales market, was selling 6,000-7,000 Goosebumps books per week in September 1995 but only 3,000 per week in September 1996. *See id.* ¶ 42; Pls.' Opp. Mem. at 6 n.8. The Caldor Corporation tracks figures daily for all Goosebumps books and these figures are available to Scholastic. In addition, a representative from one of Scholastic's distributors, Levy Home Entertainment, comes to each Caldor store weekly, checks the sales numbers and takes reorders. *See* Second Am. Compl. ¶ 38(d).

4. Trade sales of Goosebumps books through Aramark Corporation, a book distributor that sells Goosebumps products to mass retailers Target, Walmart and Kmart dropped 50% between September 1995 and the fall of 1996. *See id.* ¶ 42.

5. The Target chain tracks Goosebumps sales figures, title by title, on a weekly basis and compiles a weekly report from

this information which is sent to distributors every Monday and to the Scholastic sales department. *See id.* ¶ 38(e).

Plaintiffs now include the following additional allegations in the Second Amended Complaint:

6. Retail sales by Caldor, which had dropped to approximately 3,000 per week in the September 1996 period, declined further to approximately 1,800 per week in January 1997.

7. In September 1996, Ingram was ordering approximately 25,000 copies per title. This level declined approximately 50% during the Class Period until it reached approximately 12,000 per title in January and February 1997.

3. Increasing returns of Goosebumps books

In the Second Amended Complaint, Plaintiffs allege the following regarding Scholastic's knowledge of increasing returns of Goosebumps books:

1. Goosebumps books returned each day to the Jefferson City warehouse are entered into a computer and this information is then transferred each night to Scholastic's corporate offices.

2. Toys R Us advised Scholastic in early to mid-December 1996 that the increasing scary content of Goosebumps books was resulting in a significant increase in returns and, in December 1996, Toys R Us returned an unusually high amount of Goosebumps books.

3. By Christmas 1996, a Scholastic employee in New York told the inventory manager at the Jefferson City warehouse that the situation for Goosebumps "had taken a turn for the worse and that the returns would continue to mount because many titles were overstocked and overbought." *See id.* ¶ 46(b).

4. Returns for Levy Home Entertainment, a distributor for Goosebumps that generally ordered 100,000 copies per title, "began to rise to unprecedented levels" in November and December 1996 and "accelerated" in January 1997, when "books equivalent to 50% to 70% of October and November 1996 sales were returned to Scholastic." *See id.* ¶ 46(c).

5. "By early January 1997, the amount of returned books consigned to the employee bookstore had grown so much that there was barely room to walk into the store." *See id.* ¶ 46(d).

6. The book return rates for January 1997 amounted to approximately $4 to $5 million, a 150% increase in returns over January 1996. *See id.* ¶ 46(e).

Plaintiffs additionally claim that Scholastic attempted to conceal this decline in sales and increase in returns by engaging in a variety of aggressive sales practices prior to and during the Class period. *See id.* ¶ 44. For instance, Scholastic allegedly offered distributors discounts to accept additional shipments of Goosebumps books and extended the billing period for another 90 days — and sometimes up to six months — to encourage distributors to keep the unsold books rather than returning them. Scholastic also offered

distributors free advertising dollars, subsidized freight costs, and repackaging of Goosebumps books and merchandise at no cost. *See id.*

C. The November 1996 Goosebumps Contract

On November 27, 1996, Scholastic entered into a new agreement with Parachute Press, Inc., Goosebumps' licensor. The Second Amended Complaint provides, in part, that "Scholastic and Parachute ultimately reached a new contract on November 27, 1996. The contract provided for significant increases in payments to Parachute, including for royalty and profit-sharing." *See* Second Am. Compl. ¶ 67.[1] The contract extended Scholastic's Goosebumps publishing relationship with Parachute for an additional 3 ½ years. Under the agreement, Scholastic obtained, among other things, the exclusive rights to print, publish, manufacture, and sell 42 new Goosebumps titles and 64 Goosebumps-related works. The new contract also increased the advance per book substantially, with total advances on all new works amounting to $36,100,000. *See* Even Aff., Ex. 5. Plaintiffs now allege that a dispute between Scholastic and Parachute prior to the November 27 contract disrupted Goosebumps sales revenue in the fall of 1996.

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[1] Although Plaintiffs discuss the November 27, 1996 contract in the Second Amended Complaint, Plaintiffs nonetheless move to strike the agreement, Defendants' exhibit 5. The Court denies the request to strike. "[T]he complaint is deemed to include any written instrument attached to it as an exhibit or any statements or documents incorporated in it by reference." *See International Audiotest Network, Inc. v. AT&T*, 62 F.3d 69, 72 (2d Cir. 1995). Because the November 1996 contract is explicitly referred to in the Second Amended Complaint, and thereby incorporated by reference, the Court denies the request to strike Defendants' Exhibit 5.

Appendix B

D. The Alleged Materially False and Misleading Statements During the Class Period

1. The December 10, 1996 Press Release

On the first day of the Class period, December 10, 1996, Scholastic issued a press release announcing its results for the second quarter of 1997, the period ending November 30, 1996. In the press release, Scholastic reported net income in the quarter of $38.5 million, or $2.21 per share fully diluted. *See id.* ¶ 48. This amounted to a 24% increase over the comparable period for the previous year. Scholastic also reported revenue of $342.2 million for the quarter, a 16% increase from the comparable quarter in the prior year. Revenue for the six months totaled $500.8 million, a 17% increase from the prior year, and operating income of $46.4 million, a 16% increase from the prior year. *See id.*

2. The December 11, 1996 Conference Call

On December 11, 1996, Scholastic officers held a conference call with analysts to discuss the second quarter results. *See id.* ¶ 50. Plaintiffs allege, upon information and belief, that Defendant Marchuk participated in the conference call. *See id.* Analyst reports followed this call and disseminated this information to the market, including a Smith Barney report dated December 11, 1996, a Merrill Lynch report dated December 12, 1996, and a Deutsche Morgan Grenfell report, dated December 13, 1996. *See id.* Merrill Lynch reported that "it appears that Goosebumps' growth trajectory may be flattening slightly. We believe that product returns from the holiday season will be an important

variable to watch in Jan./Feb. as trade has increased as a proportion of sales and Goosebumps has gone to a mass market strategy." *See* Even Aff., Ex. 8, *2. The Merrill Lynch report also stated that Scholastic management indicated that the Goosebumps "front list" was demonstrating strong growth while the trade revenues with respect to the "backlist" or older Goosebumps titles was experiencing a leveling off. *See id.* ¶ 50, Even Aff., Ex. 8, * 3. Merrill Lynch also reported that "[a]t this point it is too early to say whether Goosebumps' growth is taking a breather or if a new slower trend is emerging." The report further stated that Scholastic indicated that the quarterly retail sales were "distorted" and had suffered in comparison to those of the previous year's second quarter because, in the previous year, many new retailers had loaded up on inventory in connection with the launch of the Goosebumps television series.

According to the Deutsche Morgan Grenfell report, "[g]rowth of Goosebumps is slowing from last year's high growth rate, new titles are doing better than the older titles as is to be expected. Here too, management believes that in the next year or two, assumptions of 20% growth are reasonable." *See* Second Am. Compl. ¶ 50; Even Aff., Ex. 9, at 2. In addition, the Smith Barney report provided that Scholastic "[was] most comfortable with EPS estimates at the lower end of the First Call Consensus range [for the following quarter]." *See* Second Am. Compl. ¶ 50. That range was from $.64 to $.73. Defendants received copies of these reports but did not object to any of the statements contained in the reports or ask for any corrections to be made. *See id.* ¶ 51.

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3. The December 18, 1996 Prospectus Supplement

Prior to the Class Period, on or about December 6, 1996, Scholastic announced that it had filed a Shelf Registration with the SEC for up to $150 million of securities, including debt securities, preferred and common stock. Scholastic indicated that it would use the proceeds from any offering for general corporate purposes, including repayment of bank borrowings, capital expenditures and possible acquisitions. *See id.* ¶ 37. On December 18, 1996, Scholastic announced that it had priced $125 million of notes through Goldman Sachs & Company, Alex Brown & Sons and Citicorp Securities, Inc. *See id.* ¶ 54. Scholastic's Prospectus Supplement for the notes, also dated December 18, stated that the "Company's sales in the trade market are led by the highly successful Goosebumps (Registered) series, with 68 titles and 150 million copies in print as of August 1996, and the Baby-Sitters Club (Registered) series, with 245 titles published and 149 million copies in print as of that date." The Prospectus Supplement also reported the second quarter results and stated that the "[t]rade sales remained constant from the prior year's strong second quarter performance, which had increased by 100% over the second quarter of fiscal 1995." *See id.*

4. The January 14, 1997 Form 10-Q

On or about January 14, 1997, Scholastic filed a Form 10-Q for the period ending November 30, 1996, confirming the results announced on December 10, 1996, regarding net income, revenue and operating income. *See id.* ¶ 55.

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5. The January 31, 1997 Merrill Lynch Report

On January 31, 1997, Merrill Lynch issued another report on Scholastic, raising its rating on Scholastic stock from Neutral to Accumulate. The report stated that "[c]hannel checks as well as discussions with [Scholastic's] management suggest that there has not been a surge in book returns. This is important because we have viewed higher-than-expected returns as a significant risk in the stock as the Company has moved to more mass market distribution." *See id.* ¶ 56; Even Aff., Ex. 10, at 2.

6. The February 20, 1997 Press Release

In the beginning of February, Scholastic received figures for book returns for the month of January 1997. The figures indicated that January 1997 returns were in the range of $4 million to $5 million, an increase of 150% from January 1996 levels. *See id.* ¶ 58. On February 20, 1997, Scholastic announced that for the third quarter ending February 28, 1997 it would experience a decline in Goosebumps books sales as well as higher returns of the books, and expected to post a loss of $.70-$.80 per share for the third quarter, which would include $.50 per share for the effect of a $13 million pre-tax special charge primarily consisting of a reserve for anticipated additional book returns. *See id.* ¶68; Even Aff., Ex. 11. After the announcement, Scholastic's stock value declined from $61.50 to $36.75 per share. *See* Second Am. Compl. ¶ 69.

Plaintiffs allege that Scholastic's December 10, 1996 press release, Scholastic's statements to analysts on

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December 11, 1996, the December 18, 1996 Prospectus Supplement, the January 14, 1997 second quarter Form 10-Q and Scholastic's statements in Merrill Lynch's January 31, 1997 report were false and misleading and omitted material information. First, Plaintiffs allege that Defendants knew or were reckless in not knowing that the trend of Goosebumps sales during the second quarter continued to decline and the trend of returns to increase based on Scholastic's access to the trade sales data from Goosebumps distributors and from the internal monitoring described above. *See id.* ¶¶ 49(a), 52(a), 55(a). Plaintiffs allege that "[t]hese trends were made even more significant because they occurred despite the company's efforts to boost reportable sales and defer returns as described above." *See id.* Pursuant to rules and regulations promulgated by the SEC, including Item 303 of Regulation S-K, 17 C.F.R. § 229.303, Defendants had an obligation to disclose the existence of a known trend that would likely have an impact on Scholastic's revenues, income from operations or liquidity. *See id.* ¶ 55(a). Thus, Plaintiffs allege that Defendants had a duty to update their earlier statements contained in the September 17, 1996 press release and the September 12 and 19, 1996 Merrill Lynch reports regarding Goosebumps' sales and return rates which were no longer accurate. *See id.* ¶¶ 49(b), (c), 52(b), (c), 55(b), (c).

Moreover, Plaintiffs allege that based on the downward trend in sales and the upward trend in returns, Defendants had no reasonable basis to expect that Goosebumps sales would increase by 20% as Defendants suggested in the December 13 Deutsche Morgan Grenfell report. Plaintiffs additionally claim that Defendants' statements attributing the "flattening" of Goosebumps sales for the second quarter

to primarily the "backlist" titles were materially misleading. *See id.* ¶¶ 52(d), (e), 55(d). Finally, Plaintiffs allege that Defendants had an obligation in the January 14, 1997 Form 10-Q and in the January 31, 1997 Merrill Lynch report to update Scholastic's earlier statements regarding the reasonableness of 20% growth in Goosebumps sales and the expectation that Scholastic would meet EPS estimates in the range of $.64-$.73, but failed to do so. *See id.* ¶¶ 55(d), (e), 56-57.

E. Scienter Allegations

Plaintiffs allege that Defendants acted with scienter in that Defendants knew, or recklessly disregarded, that public documents and statements issued or disseminated in the name of Scholastic were false and misleading in violation of the federal securities laws. Plaintiffs allege that Defendants' scienter is evidenced by their knowledge that Scholastic's sales were declining and its returns increasing. Plaintiffs allege that the sales figures Defendants received from its distributors and from internal monitoring "indicated that trade sales were in significant decline at least as early as the second quarter of 1997, and fell further in December 1996 and January 1997." As to knowledge of increasing returns, Plaintiffs allege that "defendants knew through daily trade returns information from Scholastic's Jefferson City Warehouse, and knew no later than the first week of February, 1997, that returns for the entire month of January 1997 returns had increased 150% over January 1996 levels." *See id.* ¶ 80.

In addition, Plaintiffs allege that Defendant Marchuk's motive and opportunity to commit securities fraud is

evidenced by his "insider selling." In four days of trading on December 31, 1996, and January 2, 3, and 7, 1997, Marchuk sold a total of 19,400 shares of Scholastic common stock for over $1.2 million. *See id.* ¶ 81. Plaintiffs allege that Defendant Marchuk had access to confidential information, was aware of the decline in retail sales of Goosebumps titles and benefitted by selling Scholastic stock at artificially inflated prices without disclosing the material adverse facts to which he was privy. Plaintiffs allege that these insider sales were unusual in their amount and/or in their timing because between April 11, 1995 and the beginning of the Class Period, Marchuk did not sell any shares of Scholastic stock and then sold 80% of his holdings between December 31, 1996 and January 7, 1997. *See id.* ¶ 81(a), (b).

Finally, Plaintiffs allege that Defendants were motivated to conceal the true state of affairs so Scholastic could complete the placement of its December 1996, $125 million debt securities offering on favorable terms. *See id.* ¶ 82.

Discussion

A. Standard of Review Under Rule 12(b)(6)

A motion to dismiss for failure to state a claim pursuant to Rule 12(b)(6) should be granted only if it "appears beyond doubt that the plaintiff can prove no set of facts in support of his claim that would entitle him to relief." *Cooper v. Parsky*, 140 F.3d 433, 440 (2d Cir. 1998) (quoting *Conley v. Gibson*, 355 U.S. 41, 45-46, 78 S.Ct. 99, 102 (1957)). The factual allegations set forth in the complaint must be accepted

as true, *see Zinermon v. Burch*, 494 U.S. 113, 118, 110 S.Ct. 975, 979 (1990), and the court must draw all reasonable inferences in favor of plaintiff. *See Thomas v. City of New York*, 143 F.3d 31, 36 (2d Cir. 1998). The issue on a motion to dismiss "is not whether . . . plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support the claims." *Villager Pond, Inc. v. Town of Darien*, 56 F.3d 375, 378 (2d Cir. 1995) (citation omitted). Nevertheless, the complaint must contain allegations concerning each of the material elements necessary to sustain recovery under a viable legal theory. *See Connolly v. Havens*, 763 F. Supp. 6, 9 (S.D.N.Y. 1991).

B. The § 10(b)/ Rule 10b-5 Claim

Section 10(b) of the Exchange Act provides, in relevant part, that it shall be unlawful "to use or employ in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe . . . ." 15 U.S.C. § 78j(b). Rule 10b-5 similarly makes it unlawful "[t]o make any untrue statement of a material fact or to omit to state a material fact" in connection with the purchase or sale of any security. 17 C.F.R. § 240.10b-5. To state a claim under § 10(b) and Rule 10b-5, a plaintiff must allege that "in connection with the purchase or sale of securities, the defendant, acting with scienter, made a false material misrepresentation or omitted to disclose material information and that plaintiff's reliance on defendant's action caused [plaintiff] injury." *Acito v. Imcera Group, Inc.*, 47 F.3d 47, 52 (2d Cir. 1995) (quoting *In re*

Time Warner Inc. Sec. Litig., 9 F.3d 259, 264 (2d Cir. 1993)); *see also San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Cos., Inc.* ("*San Leandro*"), 75 F.3d 801, 808 (2d Cir. 1996).

Plaintiffs must also satisfy the enhanced pleading requirements of Fed. R. Civ. P. 9(b) and the Private Securities Litigation Reform Act (the "PSLRA"), 15 U.S.C. §§ 78u-4(b)(1), (2) (1995). Rule 9(b) provides: "In all averments of fraud or mistake the circumstances constituting fraud or mistake shall be stated with particularity."[2] To state a claim with the required particularity, a complaint "must: (1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent." *See Stevelman v. Alias Research Inc.*, 174 F.3d 79, 84 (2d Cir. 1999) (quoting *Acito*, 47 F.3d at 51). Although Rule 9(b) also provides that "[m]alice, intent, knowledge, and other condition of mind of a person may be averred generally," the Second Circuit has established that plaintiffs must nonetheless "allege facts that give rise to a strong inference of fraudulent intent." *See Chill v. General Elec. Co.*, 101 F.3d 263, 266 (2d Cir. 1996) (quoting *Acito*, 47 F.3d at 52). A complaint may adequately plead the necessary strong inference of fraudulent intent either (a) by

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[2] The PSLRA provides that where the plaintiff alleges that a defendant made a misstatement or omission of material fact, "the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1).

alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness. *See Stevelman*, 174 F.3d at 84; *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994).

Defendants now argue that the Second Amended Complaint should be dismissed because it fails to adequately plead that Defendants made any misstatements or omissions of material fact and fails to plead the scienter element of securities fraud with the particularity required by Fed. R. Civ. P. 9(b). Defendants also argue that the Complaint fails to state a claim under Fed. R. Civ. P. 12(b)(6) because the alleged misrepresentations are not actionable.

1. Plaintiffs' Allegations that Defendants Made Misstatements or Omissions of Material Fact

The Plaintiffs' complaint in this case is that Defendants failed to disclose a trend of decreasing Goosebumps sales and increasing returns during the class period and failed to update prior statements which became misleading in light of this trend. In order to claim that Defendants violated federal securities laws by failing to disclose a trend of decreasing Goosebumps sales and increasing returns prior to February 1997, Plaintiffs must plead facts indicating that such a trend existed at the time of the alleged misstatements. *See, e.g., Glassman v. Computervision Corp.*, 90 F.3d 617, 633 (1st Cir. 1996) (noting that disclosure of a trend is mandated only for "those trends discernible from hard information alone"); *In re Quarterdeck Office Sys., Inc. Sec.*

Litig., No. 92-3970, 1992 WL 515347, at *5 (C.D. Cal. Nov. 4, 1992) (dismissing claim for failure to plead with particularity where plaintiff "fail[ed] to allege facts showing the adverse trends that should have been disclosed"). In *Scholastic I*, this Court dismissed the First Amended Complaint, finding that "Plaintiffs [did] not [satisfy] the specificity requirements of Rule 9(b) in pleading the existence of a trend of declining Goosebumps sales and increasing Goosebumps returns prior to February 1997." 1998 WL 872422, at *10. Plaintiffs' Second Amended Complaint similarly fails to plead the existence of the alleged trend with the particularity required by Rule 9(b).

a. Allegations regarding declining sales

In *Scholastic I*, the Court found that:

> To support their claim that there was a significant decline in Goosebumps retail sales, Plaintiffs cite pre-Class Period trade sales figures of three companies: AMS, which accounts for 15% of the Goosebumps trade sales market, declined by 50% between June 1995 and the fall of 1996; the Caldor Corporations's Goosebumps sales declined from 6,000 or 7,000 books per week in September 1995 to 3,000 per week in September 1996; and the Aramak Corporation's Goosebumps sales declined by 50% between September 1995 and the fall of 1996. The Complaint does not specify what percentage of the Goosebumps trade sales market either Aramark or the Caldor Corporation comprise. Although Plaintiffs allege that Ingram

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> Distribution Group, Inc., which accounts for approximately 50% of the Goosebumps trade market, experienced a "significant decrease" in Goosebumps sales in the fall of 1996, Plaintiffs provide no figures to support this allegation or to indicate how much of a decrease Ingram experienced. Moreover, all of the figures provided pertain only to the pre-Class Period. Plaintiffs allege only that the trend of Goosebumps sales in the trade channel continued to decline in November 1996, and "magnified" in December 1996 and January 1997 but do not plead any particular facts to support these allegations.

1998 WL 872422, at *9. In an effort to plead the existence of a trend of declining Goosebumps sales prior to February 1997, Plaintiffs now include two new allegations in the Second Amended Complaint in addition to the allegations discussed in *Scholastic I*:

1. Retail sales by Caldor, which had dropped to approximately 3,000 per week in the September 1996 period, declined further to approximately 1,800 per week in January 1997.

2. In September 1996, Ingram was ordering approximately 25,000 copies per title. This level declined approximately 50% during the Class Period until it reached approximately 12,000 per title in January and February 1997.

Plaintiffs claim that these two allegations of declining sales during the class period, combined with the allegations

it previously asserted in the First Amended Complaint, satisfy the pleading requirements of Rule 9(b). The Court disagrees. Plaintiffs' new allegations pertain only to trade sales in January and February 1997; there are no new allegations regarding declining trade sales in December. Thus, in support of the claim that there was a significant trend of declining Goosebumps trade sales that Defendants should have disclosed during the class period prior to February 20, 1997, the Second Amended Complaint includes new allegations relating to only one Goosebumps retailer, Caldor's, and one distributor, Ingram, and addresses declining trade sales beginning in January. Moreover, according to Plaintiffs, Caldor's accounts for only approximately 1% of the Goosebumps trade sales market. The Court therefore concludes that Plaintiffs have again failed to plead a trend of declining Goosebumps trade sales that Defendants should have disclosed prior to February 1997.[3]

b. Allegations regarding increasing returns

In *Scholastic I*, the Court found that with respect to Plaintiffs' allegations that there was a trend of increasing returns prior to February 1997:

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[3] Plaintiffs additionally allege that a dispute with Parachute disrupted Goosebumps sales revenue in the Fall 1996. However, even presuming this to be true as the Court must on this motion, Plaintiffs have not pleaded any facts to support the allegation that a contract dispute with Parachute, resulting in a new contract on November 27, 1996, led to declining Goosebumps trade sales either before or during the class period.

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> Plaintiffs similarly fail to plead with particularity that there was a trend of increasing returns prior to February 1997. Plaintiffs allege facts pertaining only to December and January book returns, which Defendants did not receive until January and February respectively. Plaintiffs offer that the monthly book return figures for December, which Plaintiffs received in the beginning of January, showed "dramatically higher returns" and that the return rate figures for January, which Defendants did not receive until the beginning of February, showed a 150% increase over January 1996. Scholastic then made an announcement on February 20, disclosing this increase in returns.

In the Second Amended Complaint, Plaintiffs include the following new allegations in an attempt to satisfy the pleading requirements of Rule 9(b):

1. Toys R Us advised Scholastic in early to mid-December 1996 that the increasing scary content of Goosebumps books was resulting in a significant increase in returns and, in December 1996, Toys R Us returned an unusually high amount of Goosebumps books.

2. By Christmas 1996, a Scholastic employee in New York told the inventory manager at the Jefferson City warehouse that the situation for Goosebumps "had taken a turn for the worse and that the returns would continue to mount because many titles were overstocked and overbought."

3. Returns for Levy Home Entertainment, a distributor for Goosebumps that generally ordered 100,000 copies per title,

"began to rise to unprecedented levels" in November and December 1996 and "accelerated" in January 1997, when "books equivalent to 50% to 70% of October and November 1996 sales were returned to Scholastic."

4. "By early January 1997, the amount of returned books consigned to the employee bookstore had grown so much that there was barely room to walk into the store."

The Court finds that none of these additional allegations satisfy the pleading requirements of Rule 9(b) to allege a trend of increasing returns prior to February 1997. Plaintiffs' new allegations again pertain to December and January book returns which, as the Court noted above, Defendants did not receive until January and February respectively. As a result, Defendants would not have received the January return figures for Levy Home Entertainment until February 1997. Moreover, the allegations pertaining to December book returns— that Toys R Us returned an "unusually high amount of Goosebumps books" and that a Scholastic employee in New York opined that "returns would continue to mount" — are too vague to satisfy the pleading requirements of Rule 9(b) and the PSLRA.

For the reasons discussed above, the Court concludes that Plaintiffs have again failed to satisfy the specificity requirements of Rule 9(b) in pleading the existence of a trend of declining Goosebumps sales and increasing Goosebumps returns prior to February 1997. Thus, Plaintiffs have failed to adequately plead that the statements in question were fraudulent and cannot withstand Defendants' motion to dismiss the Second Amended Complaint.

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2. The Scienter Requirement

Because Plaintiffs have not adequately pleaded the existence of the alleged trend, the Court need not address Plaintiffs' allegations of scienter. Nevertheless, Plaintiffs' allegations in the Second Amended Complaint would again fail to satisfy the pleading requirements of Rule 9(b) and the PSLRA.

a. Conscious Misbehavior or Recklessness

The Second Amended Complaint asserts that Defendants acted with scienter in that they knew or recklessly disregarded that statements issued in the name of Scholastic during the class period were false and misleading, based on Defendants' knowledge that Scholastic's sales were decreasing and its returns increasing from access to sales figures of major distributors and from internal monitoring.

Accepting the factual allegations in the Second Amended Complaint as true, the Court nonetheless finds that Plaintiffs have not sufficiently alleged that any of the statements made during the class period — Scholastic's December 10, 1996 press release, Scholastic's statements to analysts on December 11, 1996, the December 18, 1996 Prospectus Supplement, the January 14, 1997 second quarter Form 10-Q and Scholastic's statements in Merrill Lynch's January 31, 1997 report — were false. In addition, as this Court noted in *Scholastic I*, "Plaintiffs' allegations of access [to adverse non-public information], standing alone, do not constitute strong circumstantial evidence of conscious misbehavior or recklessness on the part of the Individual Defendants."

1998 WL 872422, at *10 (quoting *In re WRT Energy Sec. Litig.*, No. 96-3610, 1997 WL 576023, at *14 (S.D.N.Y. Sept. 15, 1997)). Nor do Plaintiffs' allegations regarding the compilation of a monthly Director's Book and other internal reports analyzing trade sales figures constitute evidence of Defendants' fraudulent intent because Plaintiffs fail to allege what these internal documents indicated. *See San Leandro*, 75 F.3d at 812 ("Plaintiffs' unsupported general claim of the existence of confidential company sales reports that revealed the larger decline in sales is insufficient to survive a motion to dismiss."); *In re Silicon Graphics, Inc. Sec. Litig.*, 970 F. Supp. 746, 767 (N.D. Cal. 1997) ("To establish a strong inference of fraud, plaintiffs must provide more details about the alleged internal reports . . . [including] the titles of the reports, when they were prepared, who prepared them, to whom they were directed, their content, and the sources from which plaintiffs obtained this information."). Thus, Plaintiffs' allegations that Defendants knew or were reckless in failing to know that Scholastic's sales were decreasing and its returns increasing based on access to sales figures and from internal monitoring are insufficient to plead fraudulent intent.

The Court additionally notes that the event that precipitated this lawsuit was Scholastic's voluntary disclosure in February 1997 of negative information concerning the sales performance of Goosebumps. As found in *In re Nokia Corp, Sec. Litig.*, "the fact that [Defendant] disclosed this negative information, voluntarily, prior to the end of the reporting period, undercuts the claim that [Defendant] acted consciously to hide the truth or that it acted recklessly." 1998 WL 898334, at *6 (S.D.N.Y. Dec. 22, 1998).

b. Motive and Opportunity

As this Court discussed in *Scholastic I*, Plaintiffs' allegation that Defendants were motivated to conceal the true state of affairs so Scholastic could complete the placement of its December 1996, debt securities offering on favorable terms is insufficient to give rise to a strong inference of fraudulent intent. *See Salinger v. Projectavision, Inc.*, No. 95-4862, 1997 WL 431125, at *10 (S.D.N.Y. July 31, 1997) ("It is not sufficient . . . to plead scienter by alleging an abstract desire to enable the company to continue to enjoy a high stock price and thereby ease the difficulties of raising of additional capital."); *Glickman v. Alexander & Alexander Serv. Inc.*, 1996 WL 88579, *6 (S.D.N.Y. Feb. 29, 1996) (finding that "a desire to raise much needed capital" is an insufficient basis for an inference of scienter).

Plaintiffs next claim that Defendant Marchuk had motive and opportunity to commit fraud based on his sale of Scholastic stock during the Class Period. Insider sales of stock may be evidence of scienter if they were unusual in amount or timing. *See Acito*, 47 F.3d at 54; *In re Hudson Tech., Inc. Sec. Litig.*, No. 98 Civ. 1616 (JGK), 1999 WL 767418, *9 (S.D.N.Y. Sept. 29, 1999). Plaintiffs argue that allegations that corporate officers having access to company financial information, such as Marchuk, who make substantial sales of corporate stock while making optimistic public statements, suffice to establish opportunity and motive to commit fraud.

The Court notes, however, that the Second Amended Complaint does not allege, other than on information and belief, that Defendant Marchuk made any of the alleged misrepresentations or omissions in question. In addition,

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Marchuk's sales occurred on December 31, 1996, and January 2, 3, and 7, before any of the figures for January or February trade sales and returns were available. Moreover, the Second Circuit in *Acito*, found that the sale of stock by one director in a corporation did not give rise to a strong inference of an intent to deceive the investing public:

> [T]he complaint failed to allege that any other defendant sold any shares of [the company's] stock during this period. The fact that the other defendants did not sell their shares during the relevant class period undermines plaintiffs' claim that defendants delayed notifying the public "so that they could sell their stock at a huge profit."

47 F.3d at 54. In this case, Defendant Marchuk is the only Scholastic employee alleged to have sold shares of Scholastic stock during the class period. As in *Acito*, the Court finds here that the sale of stock by one corporate insider, Marchuk, does not give rise to a strong inference of fraudulent intent on the part of Scholastic to delay disclosing material adverse facts in order to permit Marchuk to sell Scholastic shares at artificially inflated prices.

Because the Court finds that Plaintiffs failed to plead either the existence of a trend of declining Goosebumps trade sales and increasing returns prior to February 1997 or scienter with particularity, the Court need not address Defendants' argument that the alleged misrepresentations are not actionable for a variety of other reasons.

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C. Section 20(a) Claim

To make out a prima facie case under § 20(a) of the Exchange Act, a plaintiff "must show a primary violation [of the Exchange Act] by the controlled person and control of the primary violator by the targeted defendant, and show that the controlling person was in some meaningful sense a culpable participant in the fraud perpetrated by the controlled person." *In re Hudson Tech. Sec. Litig.*, 1999 WL 767418, *13 (quoting *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1472 (2d Cir. 1996)). Because the primary violation asserted by Plaintiffs is not adequately pleaded and therefore dismissed, this Court dismisses the claim of secondary liability under § 20 of the 1934 Act against Defendant Marchuk. *See Shields*, 25 F.3d at 1132.

Conclusion

For the reasons discussed above, Defendants' motion to dismiss is granted. The Second Amended Complaint is dismissed with prejudice. *See In re Nokia*, 1998 WL 898334, *6 ("When the plaintiff is put on notice of the deficiencies in his complaint and fails to correct them in the amended complaint . . . dismissal with prejudice is proper."). The Court orders this case closed and removed from the Court's active docket.

SO ORDERED.

Dated: New York, New York
January 26, 2000

s/ John F. Keenan
JOHN F. KEENAN
United States District Judge

APPENDIX C — MEMORANDUM OPINION AND ORDER OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK DATED DECEMBER 14, 1998 AND FILED DECEMBER 15, 1998

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

97 Civ. 2447 (JFK)

In re Scholastic Corporation Securities Litigation

This Order Relates To:

All Actions

MEMORANDUM OPINION and ORDER

* * *

JOHN F. KEENAN, United States District Judge:

Plaintiffs instituted this class action suit against Defendants, alleging violations of Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. § 78j(b), Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, and Section 20(a) of the 1934 Act, 15 U.S.C. § 78t(a). Defendants now move to dismiss this action in its entirety for failure to state a claim upon which relief can be granted, pursuant to Fed. R. Civ. P. 12(b)(6), and for failure to plead fraud with sufficient particularity, pursuant to Fed. R. Civ. P. 9(b). For the reasons discussed below, the motion is granted and the Consolidated Amended Complaint is dismissed.

Appendix C

Background

The Complaint alleges the following facts, which the Court presumes to be true for purposes of this motion.[1]

Plaintiffs brought this class action on behalf of all persons who purchased the common stock of Scholastic Corporation ("Scholastic") between December 10, 1996, and February 20, 1997 (the "Class Period"). Plaintiffs claim that Scholastic and two of its senior officers issued false and misleading statements during the Class Period in violation of § 10(b) and Rule 10b-5 which artificially inflated Scholastic's stock price and induced Plaintiffs to purchase Scholastic stock while Scholastic insiders sold significant portions of their own shares of Scholastic stock at inflated prices. Claims are also asserted against the senior officers named in the Complaint, Kevin McEnery and Ray Marchuk, as "controlling persons" under § 20(a).

Defendant Scholastic is a Delaware corporation with its principal executive offices at 555 Broadway, New York, New York. *See* Compl. ¶ 13. Scholastic's common stock is publicly traded on the NASDAQ National Market System under the symbol "SCHL." *See id.* Scholastic is in the business of publishing and distributing children's books, classroom and professional magazines and other educational products, and has operations in the United States, Canada and worldwide. Scholastic's books are sold through book clubs (43% of domestic book publishing revenues), book

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[1] "Complaint," or "Compl." refers to the Consolidated Amended Class Action Complaint filed on August 13, 1997.

fairs (19%), trade (21%), instructional publishing (13%) and classroom/library (4%). *See id.* ¶ 28. In recent years, Scholastic's most successful product has been a series of books written by R.L. Stine known as the "Goosebumps" series. *See id.* ¶ 29. There are more than sixty titles in the Goosebumps series with 150 million copies in print. Goosebumps' sales represented approximately 15% of Scholastic's gross revenues in the 1996 fiscal year. *See id.*

Defendant Kevin McEnery is and was, at all relevant times, the Executive Vice-President and Chief Financial Officer of Scholastic. *See id.* ¶ 14. Defendant Ray Marchuk is and was, at all relevant times, Vice-President for Financial and Investor Relations of Scholastic. *See id.* ¶ 15. Marchuk was responsible for Scholastic's communications with investors and industry analysts.

1. Scholastic's Trade Sales and Book Return Rates in the Pre-Class Period

Although Scholastic traditionally marketed its books through schools and specialty stores, prior to the Class Period, Scholastic expanded its distribution of Goosebumps to mass merchandisers and retailers, including Walmart, Caldor and various "price clubs." *See* Compl. ¶ 30. Scholastic ships books to retailers and distributors with a full right of return. Pursuant to Generally Accepted Accounting Principles ("GAAP"), a company can recognize a sale and record revenues on shipments to the retailer as long as there is an adequate reserve provision for books which may be returned. *See id.* ¶ 31. Historically, Scholastic had one of the lowest book return rates in the industry, ranging from

15-20% where rates as high as 35% were not uncommon in the business. *See id.* ¶¶ 32, 35.

On September 12, 1996, Merrill Lynch issued a report on Scholastic based on a meeting with Scholastic senior officers, including, upon information and belief, the individual Defendants. *See id.* ¶ 35. According to the report, the return rate on Goosebumps was tracking at less than 20% and Scholastic expected that its expansion into mass retail could cause the return rate to increase "modestly" above 20%. *See id.* In addition, Merrill Lynch reported that "the issue of managing return exposure is one that gets considerable management attention [at Scholastic]." *See id.* Merrill Lynch issued another report on September 19, 1996, also based on information provided by Scholastic senior officers, which reported that Scholastic's "return rates remain among the lowest in the industry at less than 20%, which might suggest that Goosebumps has been somewhat underdistributed." *See id.* ¶ 36. Defendants did not object to any of the statements contained in the report. *See id.*

Scholastic issued a press release on September 17, 1996 announcing its results for the first quarter of fiscal 1997, the period ending August 31, 1996, reporting a net loss of $14 million, or $.88 per share, compared to a net loss of $9.8 million, or $.62 per share in the same period in the previous year. *See id.* ¶ 44. The press release noted that Scholastic's first fiscal quarter "historically produces an operating loss due to higher expenses without accompanying revenues during the summer months" and stated that the Goosebumps book series "continued to sell well in trade." *See id.*

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2. Scholastic's Knowledge of Declining Goosebumps Sales and Increasing Returns

Plaintiffs claim that Scholastic had knowledge that trade sales of Goosebumps were in decline and book return rates on the rise prior to and during the Class Period. Plaintiffs claim that Scholastic had knowledge pursuant to its internal monitoring of trade sales and book returns and from access to Goosebumps sales figures from Scholastic distributors. As to internal monitoring, Defendant Marchuk, along with Scholastic's Comptroller, compiled and distributed to the Board of Directors on a monthly basis a "Director's Book" which analyzed the trade sales figures obtained from distributors and retailers and provided commentary on sales trends. *See id.* ¶ 38. Trade sales figures were also sent to the head of each Scholastic division on a weekly basis. In addition, the Sales Department received trade book sales reports, title by title, on a weekly basis from Scholastic's Jefferson City, Missouri warehouse — the warehouse through which Scholastic processes and fulfills most orders for trade distribution. Goosebumps books returned each day to the Jefferson City warehouse are entered into a computer and this information is then transferred each night to Scholastic's corporate offices. *See id.*

In addition, Plaintiffs allege that Scholastic had access to Goosebumps sales figures from Scholastic distributors. For example, Advanced Marketing Services Incorporated ("AMS"), a distributor that sells Goosebumps to warehouse outlets and represents 15% of the Goosebumps trade sales market, downloads point-of-sale data ("POS data"), which includes sales and inventory figures, into its computers on a

daily basis and Scholastic is permitted to download that information. *See id.* ¶ 37(a). AMS was selling 20,000 sets of Goosebumps, with four books in a set, per week in June 1995 but only 10,000 sets per week in the fall of 1996 — a 50% drop. Ingram Distribution Group, Inc., which accounts for approximately 50% of the Goosebumps trade market, also collects POS data which is available to Scholastic. *See id.* ¶ 37(c). Ingram likewise experienced a "significant decrease" in Goosebumps sales in the fall of 1996. *See id.* ¶ 38. The Caldor Corporation, a major retailer, was selling 6,000-7,000 Goosebumps books per week in September 1995 but only 3,000 per week in September 1996. *See id.* ¶ 41. The Caldor Corporation tracks figures daily for all Goosebumps books and these figures are available to Scholastic. In addition, a representative from one of Scholastic's distributors, Levy, comes to each Caldor store weekly, checks the sales numbers and takes reorders. *See id.* ¶ 37(d). Trade sales of Goosebumps books through Aramark Corporation, a book distributor that sells Goosebumps products to mass retailers Target, Walmart and Kmart also dropped 50% between September 1995 and the fall of 1996. *See id.* ¶ 41. Target tracks Goosebumps sales figures, title by title, on a weekly basis and compiles a weekly report from this information which is sent to distributors every Monday and to the Scholastic sales department. *See id.* ¶ 37(e).

Plaintiffs allege that the trend of Goosebumps sales in the trade channel continued to decline and the trend of book returns to increase in November, December and January. *See id.* ¶¶ 47, 55. Plaintiffs maintain that by the first week of January 1997, Defendants received monthly book return figures for December 1996 which showed "dramatically"

higher returns. *See id.* ¶ 6. In the beginning of February 1997, Defendants then received the book return rates for January 1997, which showed a 150% increase in returns over January 1996. *See id.*

Plaintiffs claim that Scholastic attempted to conceal this decline by engaging in a variety of aggressive sales practices prior to and during the Class period. *See id.* ¶ 43. For instance, Scholastic allegedly offered distributors discounts to accept additional shipments of Goosebumps books and extended the billing period for another 90 days — and sometimes up to six months — to encourage distributors to keep the unsold books rather than returning them. *See id.* Scholastic also offered distributors free advertising dollars, subsidized freight costs, and repackaging of Goosebumps books and merchandise at no cost. *See id.*

3. The Alleged Materially False and Misleading Statements During the Class Period

On the first day of the Class period, December 10, 1996, Scholastic issued a press release reporting net income in the quarter of $38.5 million, or $2.21 per share fully diluted. *See id.* ¶ 46. This amounted to a 24% increase over the comparable period for the previous year. Scholastic also reported revenue of $342.2 million for the quarter, a 16% increase from the prior year. Revenue for the six months totaled $500.8 million, a 17% increase from the prior year, and operating income of $6.4 million, a 16% increase from the prior year. *See id.*

On December 11, 1996, Scholastic officers held a conference call with analysts to discuss the second quarter

results. *See id.* ¶ 48. Plaintiffs allege, upon information and belief, that the individual Defendants participated in the conference call. *See id.* Analyst reports followed this call, including a Smith Barney report dated December 11, 1996, a Merrill Lynch report dated December 12, 1996, and a Deutsche Morgan Grenfell report, dated December 13, 1996, and disseminated this information to the market. *See id.* These reports specified that Scholastic Management made the statements contained in the reports. *See id.* ¶ 49. The Merrill Lynch report stated that the Goosebumps "front list" was demonstrating strong growth and that any "flattening" of trade revenues was occurring mainly with respect to the "backlist" or older Goosebumps titles. *See id.* ¶ 48. According to the Deutsche Morgan Grenfell report, Defendants continued to assert that a 20% growth in Goosebumps retail sales was still reasonable. In addition, the Smith Barney report provided that Scholastic "[was] most comfortable with EPS estimates at the lower end of the First Call Consensus range [for the following quarter]." That range was from $.64 to $.73. *See id.* Defendants received copies of these reports but did not object to any of the statements contained in the reports or ask for any corrections to be made. *See id.* ¶ 49.

Prior to the Class Period, on or about December 6, 1996, Scholastic announced that it had filed a Shelf Registration with the SEC for up to $150 million of securities. Scholastic indicated that it would use the proceeds from any offering for general corporate purposes, including repayment of bank borrowings, capital expenditures and possible acquisitions. *See id.* ¶ 45. On December 18, 1996, Scholastic announced that it had priced $125 million of notes through Goldman

Sachs & Company, Alex Brown & Sons and Citicorp Securities, Inc. *See id.* ¶ 52. Scholastic's Prospectus Supplement for the notes, also dated December 18, reported the second quarter results and stated that "[t]rade sales remained constant from the prior year's strong second quarter performance, which had increased by 100% over the second quarter of fiscal 1995." *See id.*

On or about January 14, 1997, Scholastic filed a Form 10-Q for the period ending November 30, 1996, confirming the results announced on December 10, 1996, regarding net income, revenue and operating income. Defendant McEnery signed the second quarter 10-Q form. *See id.* ¶ 14.

On January 31, 1997, Merrill Lynch issued another report on Scholastic, raising its rating on Scholastic stock from Neutral to Accumulate. The report stated that "[c]hannel checks as well as discussions with [Scholastic's] management suggest that there has not been a surge in book returns." *See id.* ¶ 54; Defs.' Mem. Of Law in Supp. of its Mot. to Dismiss, Ex. 14 at 2. Merrill Lynch explained that "this is important because we have viewed higher-than-expected returns as a significant risk in the stock as the Company has moved to more mass market distribution." *See* Compl. ¶ 54. As Scholastic's third quarter was drawing to a close, Defendants maintained that returns were still at "normal" levels — previously represented to be between 15 and 20% — in response to Merrill Lynch's inquiries. *See id.* ¶ 56.

In the beginning of February, Scholastic received figures for book returns in the month of January, indicating an

increase of 150% from January 1996 levels. *See id.* ¶ 58. On February 20, 1997, Scholastic announced that it had been experiencing a marked decline in Goosebumps books sales as well as sharply higher returns of the books, and expected to post a loss of $.70-$.80 per share for the third quarter, which included $.50 per share for the effect of a $13 million pre-tax special charge primarily consisting of a reserve for anticipated additional book returns. *See id.* ¶60. After the announcement, Scholastic's stock value declined from $61.50 to $36.75 per share. *See id.* ¶ 61. Merrill Lynch issued reports on February 21, 25 and 28, questioning whether Scholastic had been forthcoming about its problems with sales and return rates of Goosebumps when asked in the weeks prior to the February 20 announcement. *See id.* ¶¶ 62-64.

Plaintiffs allege that Scholastic's December 10, 1996 press release, Scholastic's statements to analysts on December 11, 1996, the December 18, 1996 Prospectus Supplement, the January 14, 1997 second quarter Form 10-Q and Scholastic's statements in Merrill Lynch's January 31, 1997 report were false and misleading and omitted material information. First, Plaintiffs allege that Defendants knew or were reckless in not knowing that the trend of Goosebumps sales during the second quarter continued to decline and the trend of returns to increase based on Scholastic's access to the trade sales data from Goosebumps distributors and from the internal monitoring described above. *See id.* ¶¶ 47(a), 50(a). Pursuant to rules and regulations promulgated by the SEC, including Item 303 of Regulation S-K, 17 C.F.R. §229.03, Defendants had an obligation to disclose the existence of a known trend that

would likely have an impact on Scholastic's revenues, income from operations or liquidity. *See id.* ¶ 53(a). Thus, Plaintiffs allege that Defendants had a duty to update their earlier statements contained in the September 17, 1996 press release and the September 12 and 19, 1996 Merrill Lynch reports regarding Goosebumps' sales and return rates which were no longer accurate. *See id.* ¶¶ 48(b), (c), 50(b), (c), 53(b).

Moreover, Plaintiffs allege that based on the downward trend in sales and the upward trend in returns, Defendants had no reasonable basis to expect that Goosebumps sales would increase by 20% as Defendants suggested in the December 13 Deutsche Morgan Grenfell report. Plaintiffs additionally claim that Defendants' statements attributing the "flattening" of Goosebumps sales for the second quarter to primarily the "backlist" titles were materially misleading. *See id.* ¶¶ 50(d), (e). Finally, Plaintiffs allege that Defendants had an obligation in the January 14, 1997 Form 10-Q and in the January 31, 1997 Merrill Lynch report to update Scholastic's earlier statements regarding the reasonableness of 20% growth in Goosebumps sales and the expectation that Scholastic would meet EPS estimates in the range of $.64-$.73, but failed to do so. *See id.* ¶¶ 53(d), (e), 55-57.

4. Scienter Allegations

Plaintiffs allege that Defendants acted with scienter in that Defendants knew, or recklessly disregarded, that public documents and statements issued or disseminated in the name of Scholastic were false and misleading in violation of the federal securities laws. Plaintiffs allege that Defendants'

knowledge that Scholastic's sales were declining and its returns increasing is evidenced by its access to trade book sales from its distributors listed above and from Scholastic's internal monitoring in the form of the monthly Director's book and daily book return information from the Jefferson City warehouse. *See* Compl. ¶ 72.

In addition, Plaintiffs allege that the individual Defendants' motive and opportunity to commit securities fraud is evidenced by their "insider selling." In the pre-Class Period, between February 1996 and November 15, 1996, McEnery exercised options for and immediately sold the underlying Scholastic common stock for 25,500 shares in twelve separate transactions. *See* Defs.' Mem. Of Law in Supp. of its Mot. to Dismiss, Ex. 16. Between September 30 and November 15, 1996, McEnery exercised options for and immediately sold the underlying stock for 15,500 of those shares, yielding a profit of $600,000. *See* Compl. ¶ 73(b). During the Class Period, McEnery exercised options for another 5,000 shares at $34.50 per share, which he then sold at market prices ranging from $60.25 to $63.00, realizing a profit of $137,000. *See id.* ¶ 14. In four days of trading on December 31, 1996, and January 2, 3, and 7, 1997, Marchuk sold a total of 19,400 shares of Scholastic common stock at prices ranging between $65.25 and $65.62, realizing over $1,250,000 in gross proceeds. *See id.* Plaintiffs allege that Defendants McEnery and Marchuk had access to confidential information, were aware of the decline in retail sales of Goosebumps titles and benefitted by selling Scholastic stock at artificially inflated prices without disclosing the material adverse facts to which they were privy. *See id.* ¶ 73. Plaintiffs allege that these insider sales were unusual in their amount

and/or in their timing because between April 11, 1995 and the beginning of the Class Period, Marchuk did not sell any Scholastic stock and then sold 19,400 shares in the Class Period. *See id.* ¶ 73(a). Plaintiffs allege that McEnery's sales were unusual because in the entire 1996 fiscal year, McEnery exercised only 10,000 of his exercisable options.

Finally, Plaintiffs allege that Defendants were motivated to conceal the true state of affairs so Scholastic could complete the placement of its December 1996, $125 million debt securities offering on favorable terms. *See id.* ¶ 74.

Procedural History

Plaintiffs filed suit on April 7, 1997, and filed the Consolidated Amended Complaint on August 13, 1997. Defendants then filed this Motion to Dismiss on October 29, 1997. In an Opinion dated September 1, 1998, the Court granted Plaintiffs' Motion to Strike Defendants' Exhibits 5, 6, 7, 9 and 13 from consideration on the Motion to Dismiss, pursuant to Fed. R. Civ. P. 12(b) and 56(f), but denied the motion to convert Defendants' Motion to Dismiss into a Motion for Summary Judgment.

Plaintiffs' Consolidated Amended Complaint alleges that: (1) all Defendants violated § 10(b) and Rule 10b-5 by making untrue statements and/or omissions of material fact which artificially inflated the price of Scholastic securities and caused Plaintiffs to purchase the Scholastic common stock at the inflated prices; and (2) Defendants Marchuk and McEnery violated § 20(a) as controlling persons of Scholastic.

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Defendants now move to dismiss, arguing that: (1) Plaintiffs fail to adequately allege that Defendants made any misstatements or omissions of material fact; and (2) Plaintiffs fail to allege facts sufficient to establish scienter.

Discussion

A. Standard of Review Under Rule 12(b)(6)

A motion to dismiss for failure to state a claim pursuant to Rule 12(b)(6) should be granted only if it "appears beyond doubt that the plaintiff can prove no set of facts in support of his claim that would entitle him to relief." *Cooper v. Parsky*, 140 F.3d 433, 440 (2d Cir. 1998) (quoting *Conley v. Gibson*, 355 U.S. 41, 45-46, 78 S.Ct. 99, 102 (1957)). The factual allegations set forth in the complaint must be accepted as true, *see Zinermon v. Burch*, 494 U.S. 113, 118, 110 S.Ct. 975, 979 (1990), and the court must draw all reasonable inferences in favor of plaintiff. *See Thomas v. City of New York*, 143 F.3d 31, 36 (2d Cir. 1998). The issue on a motion to dismiss "is not whether . . . plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support the claims." *Villager Pond, Inc. v. Town of Darien*, 56 F.3d 375, 378 (2d Cir. 1995) (citation omitted). Nevertheless, the complaint must contain allegations concerning each of the material elements necessary to sustain recovery under a viable legal theory. *See Connolly v. Havens*, 763 F. Supp. 6, 9 (S.D.N.Y. 1991).

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B. The § 10(b)/ Rule 10b-5 Claim

Section 10(b) of the Exchange Act provides, in relevant part, that it shall be unlawful "to use or employ in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe . . . ." 15 U.S.C. § 78j(b). Rule 10b-5 similarly makes it unlawful "[t]o make any untrue statement of a material fact or to omit to state a material fact" in connection with the purchase or sale of any security. 17 C.F.R. § 240.10b-5. To state a claim under § 10(b) and Rule 10b-5, a plaintiff must allege that "in connection with the purchase or sale of securities, the defendant, acting with scienter, made a false material misrepresentation or omitted to disclose material information and that plaintiff's reliance on defendant's action caused [plaintiff] injury." *In re Credit Suisse First Boston Corp. Sec. Litig.*, No. 97 Civ. 4760, 1998 WL 734365, at *4 (S.D.N.Y. Oct. 20, 1998) (quoting *Acito v. Imcera Group, Inc.*, 47 F.3d 47, 52 (2d Cir. 1995)); *see also San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Cos., Inc.*, ("*San Leandro*") 75 F.3d 801, 808 (2d Cir. 1996).

Plaintiffs must also satisfy the enhanced pleading requirements of Fed. R. Civ. P. 9(b) and the pleading requirements of the Private Securities Litigation Reform Act (the "PSLRA"), 15 U.S.C. §§ 78u-4(b)(1), (2) (1995). Rule 9(b) provides that "[i]n all averments of fraud . . . the circumstances constituting fraud . . . shall be stated with particularity. Malice, intent, knowledge, and other condition

of mind . . . may be averred generally." The PSLRA now requires that where the plaintiff alleges that a defendant made a misstatement or omission of material fact, "the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1).

Notwithstanding Rule 9(b)'s lower pleading requirements for scienter, the Second Circuit has held that "plaintiffs must allege facts that give rise to a strong inference of fraudulent intent." *See Chill v. General Elec., Co.*, 101 F.3d 263, 266 (2d Cir. 1996) (quoting *Acito v. Imcera Group, Inc.*, 47 F.3d 47, 52 (2d Cir. 1995)). Prior to adoption of the PSLRA, a plaintiff could establish a strong inference of fraudulent intent "either (a) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness." *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994); *see also Chill*, 101 F.3d at 267; *San Leandro*, 75 F.3d at 808. The PSLRA adopted the strong inference standard of Second Circuit, *see* 15 U.S.C. § 78u-4(b)(2) ("the complaint shall . . . state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind"), but a question remains as to whether Congress also adopted the various methods of proving that standard. *See In re Credit Suisse First Boston Corp. Sec. Litig.*, 1998 WL 734365, at *9-*10; *Mishkin v. Agoloff*, No. 97 Civ. 2690, 1998 WL 651065, at *21 (S.D.N.Y. Sept. 23, 1998). While

the conscious misbehavior or recklessness standard remains sufficient to plead scienter under the PSLRA, *see Securities and Exchange Commission v. U.S. Environmental, Inc.*, 155 F.3d 107, 111 (2d Cir. 1998), it is unclear whether the motive and opportunity standard survives the adoption of the PSLRA. *See The High View Fund, L.P. v. Hall*, No. 98 Civ. 1390, 1998 WL 760245,*5 n.2 (S.D.N.Y. Oct. 30, 1998) (listing cases which have come out both ways); *In re Credit Suisse First Boston Corp., Sec. Litig.*, 1998 WL 734365, at *10; *Mishkin v. Agoloff*, 1998 WL 651065, at * 21. The Court need not consider whether the motive and opportunity standard survives, however, to decide the present motion.

Defendants argue that the Complaint should be dismissed because: (1) Plaintiffs fail to allege that Defendants made any misstatements or omissions of material fact; and (2) Plaintiffs fail to allege facts sufficient to establish Defendants' scienter.

1. Plaintiffs' Allegations that Defendants Made Misstatements or Omissions of Material Fact

In order to claim that Defendants violated federal securities laws by failing to disclose a trend of decreasing Goosebumps sales and increasing returns prior to February 1997, Plaintiffs must plead facts indicating that such a trend existed at the time of the alleged misstatements. *See, e.g., Glassman v. Computervision Corp.*, 90 F.3d 617, 633 (1st Cir. 1996) (noting that disclosure of a trend is mandated only for "those trends discernible from hard information alone"); *In re Quarterdeck Office Sys., Inc. Sec. Litig.*, No. 92-3970, 1992 WL 515347, at *5 (C.D. Cal. Nov. 4, 1992) (dismissing

claim for failure to plead with particularity where plaintiff "fail[ed] to allege facts showing the adverse trends that should have been disclosed"). In this case, Plaintiffs have failed to plead the existence of the alleged trend with the particularity required by Rule 9(b).

To support their claim that there was a significant decline in Goosebumps retail sales, Plaintiffs cite pre-Class Period trade sales figures of three companies: AMS, which accounts for 15% of the Goosebumps trade sales market, declined by 50% between June 1995 and the fall of 1996; the Caldor Corporations's Goosebumps sales declined from 6,000 or 7,000 books per week in September 1995 to 3,000 per week in September 1996; and the Aramak Corporation's Goosebumps sales declined by 50% between September 1995 and the fall of 1996. The Complaint does not specify what percentage of the Goosebumps trade sales market either Aramark or the Caldor Corporation comprise. Although Plaintiffs allege that Ingram Distribution Group, Inc., which accounts for approximately 50% of the Goosebumps trade market, experienced a "significant decrease" in Goosebumps sales in the fall of 1996, Plaintiffs provide no figures to support this allegation or to indicate how much of a decrease Ingram experienced. Moreover, all of the figures provided pertain only to the pre-Class Period. Plaintiffs allege only that the trend of Goosebumps sales in the trade channel continued to decline in November 1996, and "magnified" in December 1996 and January 1997 but do not plead any particular facts to support these allegations.

Plaintiffs similarly fail to plead with particularity that there was a trend of increasing returns prior to February 1997.

Plaintiffs allege facts pertaining only to December and January book returns, which Defendants did not receive until January and February respectively. Plaintiffs offer that the monthly book return figures for December, which Plaintiffs received in the beginning of January, showed "dramatically higher returns" and that the return rate figures for January, which Defendants did not receive until the beginning of February, showed a 150% increase over January 1996. Scholastic then made an announcement on February 20, disclosing this increase in returns.

In sum, Plaintiffs have not satisfied the specificity requirements of Rule 9(b) in pleading the existence of a trend of declining Goosebumps sales and increasing Goosebumps returns prior to February 1997. Thus, Plaintiffs have failed to adequately plead fraud and cannot withstand Defendants' Motion to Dismiss.

2. Plaintiffs' Allegations of Scienter

Because Plaintiffs have not adequately pleaded the existence of the alleged trend, I need not address Plaintiffs' allegations of scienter. Nonetheless, I note that Plaintiffs' allegations would similarly fail to satisfy the pleading requirements of Rule 9(b) and the PSLRA. The Complaint asserts that Defendants had knowledge or recklessly disregarded that Scholastic's sales were decreasing and its returns increasing based on access to the trade sales figures of major distributors and from Scholastic's internal monitoring. As this Court has previously noted, however, "Plaintiffs' allegations of access [to adverse non-public information], standing alone, do not constitute strong

circumstantial evidence of conscious misbehavior or recklessness on the part of the Individual Defendants." *In re WRT Energy Sec. Litig.*, No. 96-3610, 1997 WL 576023, at *14 (S.D.N.Y. Sept. 15, 1997); *see also San Leandro*, 75 F.3d at 812 ("Plaintiffs' unsupported general claim of the existence of confidential company sales reports that revealed the larger decline in sales is insufficient to survive a motion to dismiss."); *In re Silicon Graphics, Inc. Sec. Litig.*, 970 F. Supp. 746, 767 (N.D. Cal. 1997) ("To establish a strong inference of fraud, plaintiffs must provide more details about the alleged internal reports . . . [including] the titles of the reports, when they were prepared, who prepared them, to whom they were directed, their content, and the sources from which plaintiffs obtained this information.").

In addition, Plaintiffs' allegations of motive and opportunity, if the motive and opportunity standard survives the adoption of the PSLRA, fail to meet the pleading requirements of Rule 9(b). Plaintiffs' allegation that Defendants were motivated to conceal the true state of affairs so Scholastic could complete the placement of its December 1996, debt securities offering on favorable terms is insufficient to give rise to a strong inference of fraudulent intent. *See Salinger v. Projectavision, Inc.*, No. 95-4862, 1997 WL 431125, at *10 (S.D.N.Y. July 31, 1997) ("It is not sufficient . . . to plead scienter by alleging an abstract desire to enable the company to continue to enjoy a high stock price and thereby ease the difficulties of raising of additional capital."); *Glickman v. Alexander & Alexander Serv. Inc.*, 1996 WL 88579, *6 (S.D.N.Y. Feb. 29, 1996) (finding that "a desire to raise much needed capital" is an insufficient basis for an inference of scienter).

Moreover, at least with respect to Defendant McEnery, Plaintiffs have failed to sufficiently plead motive and opportunity based on McEnery's sale of Scholastic stock during the Class Period. Insider sales of stock may be evidence of scienter if they were unusual in amount or timing. *See In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1117 (9th Cir. 1989); *see also Acito*, 47 F.3d at 54 (finding that an inference of scienter was not permitted where plaintiffs failed to establish that insider's stock sales were "unusual" and upholding dismissal of claim). In the twelve-month period from February 1996 through January 1997, McEnery exercised options and immediately sold the shares in fourteen separate transactions, totaling 30,500 shares. During the Class Period, McEnery exercised options for and then sold a total of 5,000 of the above shares — 3,000 shares on January 10 and 2,000 shares on January 16, 1997. Thus, there is no indication that McEnery's sales were unusual in either timing or amount.

Finally, because the primary violation asserted by Plaintiffs is not adequately pleaded and therefore dismissed, this Court dismisses the claims of secondary liability under § 20 of the 1934 Act against McEnery and Marchuk. *See Shields*, 25 F.3d at 1132.

Conclusion

For the reasons set forth above, Defendants' motion to dismiss is granted and the Complaint is dismissed. Plaintiffs are hereby granted leave to amend and re-file the complaint within 30 days of the date of this Opinion and Order.

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SO ORDERED.

Dated: New York, New York
December 14, 1998

s/ John F. Keenan
JOHN F. KEENAN
United States District Judge

No. 01-397

IN THE

Supreme Court of the United States

SCHOLASTIC CORPORATION and
RAYMOND MARCHUK,

Petitioners,

v.

RICHARD TRUNCELLITO and
THE CITY OF PHILADELPHIA,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF IN OPPOSITION

STEPHEN A. WHINSTON
Counsel of Record
BERGER & MONTAGUE, P.C.
1622 Locust Street
Philadelphia, PA 19103
(215) 875-3000

JEFFREY A. KLAFTER
BERNSTEIN LITOWITZ BERGER
& GROSSMANN LLP
1285 Avenue of the Americas
New York, NY 10019
(212) 554-1400

Attorneys for Respondents

170398

COUNSEL PRESS
(800) 274-3321 • (800) 359-6859

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STATEMENT OF THE CASE

Petitioners/Defendants Scholastic Corporation and Raymond Marchuk ("Petitioners") seek Supreme Court review of a ruling by the United States Court of Appeals for the Second Circuit which concluded that the [Corrected] Second Consolidated Amended Class Action Complaint (the "Complaint") stated a cause of action under Sections 10(b) and 20(a) of the Securities Exchange Act, 15 U.S.C. §§ 78j(b) and 78t(a), as amended by the Private Securities Litigation Reform Act, 15 U.S.C. § 78u-4.

Scholastic Corporation ("Scholastic" or the "Company") is a publisher and distributor of children's books and educational products. L. 6 (¶ 13).[1] At the time in question, the Company's most popular product was the "Goosebumps" series of children's books by R.L. Stine, which represented about 15% of its gross revenue for the fiscal year ended May 31, 1996. L. 13 (¶ 28). Scholastic distributed books through various retailers and wholesalers. Its accounting policy permitted it to recognize revenue on shipment of a book, even though the distributor or wholesaler had the right of return. This was permissible under generally accepted accounting rules as long as there was an adequate reserve for returns. L. 13-14 (¶ 30). Information concerning Scholastic's sales and return rate was therefore closely watched by security analysts and investors. L. 15, 16, 29, 31 (¶¶ 34, 36, 56, 60).

To monitor distributor sales and returns, Scholastic established an extensive system to collect and analyze the appropriate information in a timely fashion. The form and frequency of this information for specified distributors

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1. Respondents' have lodged with the Court a copy of the Complaint. Citations thereto will be in the form of L. __ (¶ __), with "L." designating the page of the lodging and "¶" designating the paragraph of the Complaint. Although Petitioners ask this Court to scrutinize the adequacy of the Complaint, they have not included it in the materials they have submitted to this Court.

representing well over two-thirds of the Goosebumps trade market is set forth in ¶ 38 of the Complaint, L. 16-17. Scholastic also had its own internal monitoring system which routinely collected sales information on a weekly basis in reports to division heads and transmitted data on returns from its Jefferson City warehouse to headquarters on a daily basis. L. 17-18 (¶ 39). Directors received monthly reports. *Id.*[2]

Prior to the beginning of the Class Period,[3] Scholastic publicly touted to security analysts and investors that its return rate of approximately 15-20% was among the lowest in the industry. L. 15-16 (¶¶ 34, 36), that Goosebumps "continued to sell well in the trade," *id.* (¶ 35), and that "*the issue of managing return exposure [was] one that gets considerable management attention.*" L. 15 (¶ 34).[4]

Nevertheless, by September 1996, Plaintiffs allege that Scholastic had experienced a significant decrease in sales and increase in returns of Goosebumps books. L. 18-21 (¶¶ 41-47). The Complaint supports these allegations by citing September 1996 sales statistics for Scholastic distributors constituting well over two-thirds of its trade business which showed a sharp decline from the previous year.[5]

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2. Given the electronic data systems in place, Scholastic had the ability to collect and analyze sales and returns data on a more frequent basis as circumstances warranted.

3. The "Class Period," December 10, 1996 through February 20, 1997, is the period of time during which Plaintiffs allege that Defendants made materially false, misleading and omissive statements. L. 9 (¶ 18).

4. The market's reliance on Scholastic's internal monitoring of returns was heightened by the fact that Scholastic disclosed its accounting for returns only on an annual basis. No statistical or financial information on returns was included in Scholastic's quarterly reports. L. 13-14 (¶ 30).

5. According to the Complaint, sales to Ingram, which represented 50% of Scholastic's trade business, L. 17 (¶ 38c), had suffered a (Cont'd)

By December 10, 1996, the beginning of the Class Period, when Scholastic publicly reported its second quarter performance, declining sales and increasing returns of Goosebumps had reached such a level and had gone on for a sufficient period of time that it could no longer avoid disclosing these facts to the market without violating Federal securities laws.[6]

Specifically, Plaintiffs' Complaint alleged that several mid-December 1996 statements made by Petitioners were materially misleading and omitted material information because they were completely silent regarding the material decline in sales, the material increase in returns and the materially reduced outlook for licensing revenues.[7] Sales remained dramatically down from the previous year. L. 18-19 (¶¶ 41-43) (citing results from distributors representing over two-thirds of the Goosebumps

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(Cont'd)
"significant decrease." L. 18 (¶ 41). Advanced Marketing Services, which accounted for 15% of the trade market, had seen its Goosebumps sales drop from 80,000 books per week in June 1995 to 40,000 books per week in the fall of 1996. *Id.* Fifty percent declines in sales were also reported by Aramark and Caldor. L. 18-19 (¶ 42). Year to year comparisons are appropriate in light of the seasonal nature of Scholastic's business (relating to the school year).

6. In addition, by this time, Scholastic knew that it would not be earning "significant amounts of projected revenues" it anticipated from Goosebumps merchandise licensing fees. L. 32 (¶ 66).

7. The statements are identified with particularity in ¶¶ 48, 50 and 54 of the Complaint. L. 21-24, 26. Petitioners argue that the Complaint seeks to hold Scholastic "responsible for the analysts' statements." Pet. at 8. This is incorrect. Plaintiffs cite these analyst reports only for the statements in them which were attributed to Scholastic. Nowhere do Plaintiffs seek to hold Scholastic liable for the analysts' own views or opinions. Imposing liability on those who provide materially false information to the market through securities analysts is a well accepted principle. *See, e.g., Cooper v. Pickett*, 137 F.3d 616, 623-624 (9th Cir. 1997).

trade market). In addition, the increased returns, which the Company had sought to forestall by providing extended payment dates and other unusual incentives, L. 19 (¶ 44), had now hit the Company with considerable force. L. 20-21 (¶ 46). For example, returns through Levy Distributors reached "unprecedented levels" in November and December 1996. L. 20 (¶ 46(c)). Toys R Us returned an "unusually high amount" of Goosebumps books in December and advised the Company that this resulted from consumer complaints regarding the scary nature of the series. *Id.* (¶ 46(a)).[8]

At the same time, a dispute between Scholastic and Goosebumps author R.L. Stine over negotiations regarding the renewal of marketing rights for Goosebumps-related products came to a head. Revenue from these marketing activities was a "high margin" part of Scholastic's business and had increased 129% in the previous quarter. L. 31-32 (¶ 63). Scholastic counted on the continued receipt of these revenues and factored them into their assurances to the market regarding third quarter earnings. L. 32 (¶ 64). However, unknown to the market, things were not going well in the negotiations and during the late fall

8. Petitioners claim that the Complaint "did not allege any declining sales or rising returns during October to December, other than vaguely noting "unusually high" returns from one retailer in December. Petition ("Pet.") at 8. *See also* Pet. at 10 ("there were no specific allegations about any additional declines in sales during October to December"). This is incorrect both with regard to sales and returns. For example, the 50% drop in AMS weekly sales is alleged to have occurred by "the fall of 1996 (during the second quarter)." L. 18 (¶ 41). *See also* L. 18-19 (¶ 42) (Aramark sales dropped 50% "between September 1995 and the fall of 1996"). The fall, of course, includes the months of October and November and the first twenty-one days of December. Additionally, the point is not that there were *further* declines from September to December, although there were, but that when the drop in sales had not picked up by December, Petitioners were therefore obligated to disclose that fact, *i.e.*, it had become a trend as opposed to a momentary drop. Petitioners' argument is symptomatic of their narrow reading of the Complaint and their insistence on not according *any* inferences in favor of Respondents.

of 1996, according to Scholastic's own pleadings in subsequent litigation, Stine's company, Parachute Press, engaged in a "campaign of obstruction and harassment" which "significantly disrupted" Scholastic's ability to earn Goosebumps licensing revenue and caused the Company to lose "significant amounts of projected revenues." *Id.* (¶ 66).

All of these facts contrast dramatically with Petitioners' rosy picture of the second quarter results, third quarter expectations and their complete silence regarding increasing sales and returns, making the mid-December statements actionable under the securities laws.[9]

Scholastic next spoke publicly to the market in mid-January. L. 27 (¶ 55). The Complaint lays out additional detailed information which became available to Scholastic in this period. In the area of sales, Scholastic's largest distributor, Ingram, accounting for over 50% of its trade business, L. 17 (¶ 38c), had cut its order in half from 25,000 copies per title to 12,000 copies per title. L. 21 (¶ 47(b)). Caldor, whose year-to-year sales had already declined 50% by September 1996 to a level of 3,000 books per week, L. 18 (¶ 42), reduced its orders further to 1,800 books per week. L. 21 (¶ 47(a)).

In the area of returns, year-to-year comparisons showed an increase of 150% in the overall level of returns in January, amounting to $4 to $5 million for the month. *Id.* (¶ 46(e)).[10]

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9. Petitioners find fault with the Complaint for not alleging "what Scholastic knew *on December 10* that should have been disclosed." Pet. at 10. However, the Complaint does precisely that in ¶ 49. L. 22-23.

10. Petitioners claim that the Complaint admits "Scholastic did not learn about [January] returns until February." Pet. at 8. This is also incorrect. While information regarding returns for the *entire* month of January was not compiled until early February, L. 30 (¶ 58), Petitioners admitted to the close monitoring of returns and the Complaint (Cont'd)

Distributor Levy returned between 50% and 70% of its October and November "purchases" in January. L. 20 (¶ 46(c)).[11]

Incredibly, even at the end of the month, Petitioners continued to deceive the market. In late January, the Merrill Lynch analyst responsible for following Scholastic spoke with Scholastic management to obtain an update on the Company and subsequently published a report on January 31, 1997 stating that the Company "suggest[ed] that there has *not* been a surge in book returns." Viewing this an "important" development, Merrill upgraded its rating on Scholastic from "neutral" to "accumulate." L. 29 (¶ 56) (emphasis added). Based on this positive report, Scholastic's stock jumped by $1.50 a share to $58.75. *Id.*

As the end of the quarter drew closer, Merrill continued to inquire of the Company regarding book return rates and the Company gladly continued to provide misinformation. In early February, *after* the returns data for the full month of January had become available showing a 150% increase over the previous January, L. 30 (¶ 58), the Company told Merrill that returns remained at "normal" levels. L. 31 (¶ 60).

Finally, with only one week left in the third quarter, Scholastic began to tell the truth on February 20, 1997. In a press release, Scholastic now told the market that it anticipated

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(Cont'd)

particularizes several sources of sales and return information that were updated on a weekly or daily basis. L. 16-18 (¶¶ 38-39). Petitioners also fault the Complaint for not specifying "the size of the decline [in sales] or giv[ing] any date on which Scholastic actually knew about those declines." Pet. at 10. Due to the dramatic deterioration of sales and returns in January and given the detailed daily and weekly sales and return data available to the Company, L. 17-18 (¶ 39), the overall January results could not have come as a shock to Petitioners.

11. *See also* L. 20-21 (¶¶ 46(b),(d)).

a *loss* of $ .70 to $ .80 per share for the quarter. L. 32-33 (¶ 68).[12] Updating its previous repeated statements that returns were well managed and at "normal" levels, L. 15, 29, 31 (¶¶ 34, 56, 60), Scholastic announced that it would take a special pre-tax charge of $13 million, consisting primarily of a reserve for additional book returns. L. 32-33 (¶ 68). Scholastic later revealed that its trade sales had declined 20% in the quarter. L. 34 (¶ 75(b)).

Given the sharp divergence of the February 20, 1997 announcement from Scholastic's previous public comments, market investors and analysts reacted in shock and dismay. Scholastic's stock sunk to a four-year low before closing at $36.75 per share on February 21, 1997, a one-day drop of $24.75, or 40% of its previous market value. L. 33 (¶ 69). Analysts that followed the stock called the Company a liar in print, *id.* (¶ 70) ("management's credibility has been shaken"); L. 34 (¶ 72) ("the timely dissemination of information remains an unrecognized problem and as such will likely persist"); *id.* (¶ 73) ("Management credibility has been damaged. The question is raised: 'what did you know and when did you know it and why'd you take so long to tell me?' ").[13]

THE DECISION BELOW

The Second Circuit, reversing the decision of the United States District Court for the Southern District of New York, held that the Complaint properly stated and pled a cause of

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12. *Cf.* L. 23-24 (¶ 50) (Company endorses earnings of $ .64 for the third quarter). The actual reported result was a loss of $ .78 per share for the quarter. L. 35 (¶ 75(d)).

13. Declining sales and increasing returns continued, as fourth quarter losses almost equaled those of the third quarter. L. 35 (Cplt. ¶ 77). Yet another special charge was taken at the end of the fourth quarter, this time in the amount of $11 million. *Id.* (Cplt. ¶ 78). Scholastic attributed fourth quarter results to "lower trade sales and higher returns (particularly related to Goosebumps)." *Id.* (Cplt. ¶ 77).

action. The Court correctly stated that, pursuant to the requirements of Section (b)(1) of the PSLRA, Plaintiffs' Complaint "shall specify each statement alleged to have been misleading, [and] the reason or reasons why the statement is misleading." Further, according to the Second Circuit, the Complaint must be stated with particularity and "identify the statements plaintiff asserts where fraudulent and why, in plaintiff's view, they were fraudulent, specifying who made them, and where and when they were made." Pet. App. 8a-9a.

The Second Circuit found that the Complaint set forth "sufficiently detailed" allegations that Defendants "knew, despite the fact that their business was cyclical, of a material downward secular trend." Pet. App. 18a. *See also* Pet. App. 17a ("with the second and third quarters covering months when revenues should have increased, plaintiffs have alleged enough to permit proofs that Scholastic should have been alerted, by decreased sales and increased returns, to negative business results in the relevant time frame"). The Court properly accepted the particularized allegations in the Complaint as establishing Defendants' knowledge or reckless disregard for the decreasing sales and increasing returns experienced by Scholastic.

> The complaint specifically sets out the distributors through which Goosebumps books were sold, and alleges declines in sales as of specific dates, some in terms of percentage and other in terms of quantity. Such information covers over two-thirds of Scholastic's trade business in Goosebumps.

Pet. App. 11a. Importantly, the Court recognized that, according to the Complaint, Defendants not only had access to point-of-sale data, "but also reviewed it." *Id.*

Similarly, the Second Circuit found allegations concerning ballooning returns sufficiently particular and in accordance with the PSLRA's heightened pleading standards. Pet. App. 13a-14a.

The Second Circuit criticized the District Court for failing "to take into account the alleged facts that Scholastic reviewed POS data made available by AMS and Caldor on a daily basis, by Target on a weekly basis and by Ingram to learn returns would be on the rise." Pet. App. 15a. Moreover, the Second Circuit applied the proper standard in evaluating Plaintiffs' allegations as to Company-generated internal reports. In this regard, the Second Circuit held that "a plaintiff needs to specify the internal reports, who prepared them and when, how firm the numbers were or which company officers reviewed them." Pet. App. 15a. The Second Circuit specifically found that Plaintiffs met this heightened standard:

> Plaintiffs have satisfied this standard by specifying who prepared internal company reports, how frequently the reports were prepared and who reviewed them. We further observe that the complaint gives additional indications as to the nature of the reports, because the allegations are immediately preceded and followed by figures from retailers to show sales were declining.

Pet. App. 16a.

The Second Circuit found as additional support Plaintiffs' allegations concerning the Company's engagement in aggressive sales practices during the Class Period in order to delay disclosure of the huge amount of book returns and delay having to set up an adequate reserve as well as the $13 million pre-tax special charge taken by the Company in February 1997 for anticipated book returns. *See, e.g.*, Pet. App. 16a (aggressive sales practices "would furnish additional support for the proposition that company officials were aware of declining sales and increasing returns"); Pet. App. 17a (the $13 million pre-tax special charge "lends yet more support to the notion that defendants had knowledge of increasing returns").

With respect to scienter, the Second Circuit reiterated its well-established rule that a complaint could survive scrutiny by (a) pleading facts demonstrating that defendants had both the motive and an opportunity to commit fraud or (b) otherwise alleging facts to show strong circumstantial evidence of defendants' conscious misbehavior or recklessness. Pet. App. 19a. With regard to Petitioner Marchuk, the Second Circuit focused principally on Plaintiffs' insider trading allegations, adhering to the Circuit's long-held view that " 'unusual' insider sales at the time of the alleged withholding of negative corporate news may permit an inference of bad faith and scienter." Pet. App. 20a. Applying this standard, the Second Circuit found that Plaintiffs' insider trading allegations, along with other facts in the Complaint, were sufficient to establish scienter as to Defendant Marchuk. Pet. App. 20a-21a.[14]

As to Petitioner Scholastic, the Second Circuit found that the Complaint sufficiently pled allegations concerning Defendants' knowing or reckless conduct. Specifically, the Second Circuit held that:

> the second amended complaint contains detailed allegations as to what defendants knew on a daily, weekly and monthly basis about the retail trade of Goosebumps books, while at the same time making public statements that painted a different picture. Defendants publicly represented that returns were not increasing and failed to adjust revenues despite

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14. The Second Circuit also accepted as additional allegations of Defendant Marchuk's motive; namely, the fact that he was primarily responsible for Scholastic's communications with investors and industry analysts, was involved in the drafting and/or disseminating false and misleading statements during the Class Period, had access to internal corporate documents and reports relating to trade sales and return data, attended management and committee meetings and prepared the Directors' Books. Pet. App. 22a.

> their knowledge of rapidly rising returns; these actions, if proven, are consistent with recklessness.

Pet. App. 24a. As evidence of Defendants' scienter, the Second Circuit found particularly compelling allegations in the Complaint concerning Scholastic's response to inquiries from Merrill Lynch in early February 1997.

> At this point, even disregarding the information ostensibly reviewed from computer runs, Scholastic knew the return rate for January 1997 had increased 150 percent from the year before. Yet by telling Merrill Lynch that return rates remained at normal levels of 20 percent, defendants acted in ways that could be found to be reckless.

Pet. App. 24a.

REASONS FOR DENYING THE WRIT

I. CERTIORARI SHOULD BE DENIED BECAUSE THE SECOND CIRCUIT'S APPLICATION OF THE STANDARDS FOR PLEADING THE CIRCUMSTANCES OF THE FRAUD WAS CONSISTENT WITH THE PSLRA AND WITH RULINGS IN OTHER CIRCUIT COURTS OF APPEALS

A grant of Certiorari would be inappropriate in this case because the detailed allegations in the Complaint satisfy the statutory requirements for pleading the circumstances of the fraud articulated in the PSLRA. The Second Circuit's application of that standard here was consistent with rulings of other circuits which have addressed this issue. This case, therefore, is not an appropriate vehicle to resolve any purported differences in pleading standards. In addition, this case is a poor candidate for review because Petitioners never raised the issue of the proper pleading standard in any of their arguments below, or, for that matter, even challenged the application of the Second Circuit's

pleading standard (as they seek to do here).[15] Thus, if the Court were to accept this issue, it would be reviewing general statements about the law that were never applied to the pleading at issue in this case.

A. The Particularized and Detailed Facts Pled in the Complaint Regarding Sales and Returns of Books Satisfy the Statutory Requirements for Specificity in Pleading the Facts Constituting Fraud

In this case, the Second Circuit found that the Complaint satisfied the heightened pleading standards under Sections 21D(b)(1) and (2) of the PSLRA.

The Court based its decision on the well-pled and particularized allegations in the Complaint which cited reports of declining sales or increasing returns of Goosebumps from fifteen different distributors and retailers starting in September 1996 and continuing throughout the Class Period. L. 16-21 (¶¶ 38-47). Additionally, the Complaint alleges that Scholastic internally monitored trade sales and returns of Goosebumps. These allegations are not merely boilerplate assertions of internal controls. Indeed, the Complaint is so particularized that it identifies the Scholastic employee responsible for compiling one such report (Leslie Lista), the title of the report ("Director's Book"), the recipients (Scholastic's Board of Directors), and the frequency of the report (monthly). L. 17-18 (¶ 39). Based on these and other allegations, the Second Circuit concluded, the Complaint "contains detailed allegations as to what Petitioners knew on a daily, weekly and monthly basis about the retail trade of Goosebumps books, while at the same time making public statements that painted a different picture."

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15. *EEOC v. Fed. Labor Relations Auth.*, 476 U.S. 19, 24 (1986) ("Our usual practice, from which we see no reason to depart on this occasion, is to refrain from addressing issues not presented in the Court of Appeals").

Pet. App. 24a. This is precisely what is required under (b)(1) of the PSLRA.

Petitioners' precise dissatisfaction with the Second Circuit opinion is not readily apparent. However, Petitioners do raise three specific areas where, they argue, the Second Circuit differs from other courts of appeals: the purported endorsement of "fraud by hindsight," Pet. at 17-18; the purported rejection of the statutory requirement to plead "all" facts, Pet. at 18-19; and the purported rejection of the statutory requirement that scienter allegations result in a "strong inference" of knowing misconduct. Pet. at 20-21. In each instance, Petitioners misread the opinion below and grossly exaggerate any differences which may exist in the language used by the appellate courts.

1. Fraud by Hindsight.

Petitioners argue that the Second Circuit inappropriately allowed Plaintiffs to plead fraud by hindsight — the use of subsequent disclosures to conclude that earlier statements were false. Pet. at 11. Petitioners are correct that the practice of pleading fraud by hindsight has been unacceptable, even before the PSLRA. Indeed, it was the Second Circuit that advanced this position over two decades ago in *Denny v. Barber*, 576 F.2d 465, 470 (2d Cir. 1978), and has reaffirmed it in numerous decisions, including most recently in *Novak v. Kasaks*, 216 F.3d 300, 309 (2d Cir. 2000), *cert. denied*, __ U.S. __, 121 S. Ct. 567 (2000) ("we have refused to allow plaintiffs to proceed with allegations of 'fraud by hindsight' "). This principle, moreover, is consistent with the law in other circuits. *See, e.g., Silicon Graphics*, 183 F.3d at 988.

To contend, as Petitioners do here, that the Second Circuit violated this well-established precept and *sub silentio* overruled twenty-five years of precedents is patently absurd. Petitioners construct this argument from the court's acknowledgement that Scholastic's post-class period announcement of a special charge for book returns supported the inference of fraud established

by other allegations in the Complaint. The Second Circuit did not base its holding that fraud was sufficiently pled solely on Petitioners' subsequent announcements. Rather, as the Court explained (and Petitioners choose to ignore), Scholastic's post-class period announcement represented *additional* evidence establishing Petitioners' state of mind. Pet. App. 17a (the charge "lends yet more support"). The Second Circuit did not consider this post Class Period event in a vacuum. The consideration of this type of allegation as additional evidence of fraud is consistent with the Second Circuit's prior holdings (which Petitioners never challenged below on this point)[16] as well as precedent in other circuits, including the Ninth Circuit.

Indeed, an analysis of case law from other circuits demonstrates a consistency in the recognition that post-class period disclosures which are inconsistent with recently made statements during the class period may tend to show that the latter were misleading. This jurisprudence is particularly well developed in the Ninth Circuit. *Fecht v. Price Co.*, 70 F.3d 1078, 1083-84 (9th Cir. 1995), *cert. denied*, 517 U.S. 1136 (1996) ("shortness of time [between negative post-class period disclosure and optimistic class period statements] is circumstantial evidence that the optimistic statements were false when made"); *Cooper v. Pickett*, 137 F.3d 616, 627 (9th Cir. 1997) (short time period between post-class period disclosure of negative information and positive class period statements suggests "fraud, rather than business mistake viewed with the benefit of hindsight"); *Ronconi v. Larkin*, 253 F.3d 423, 437 (9th Cir. 2001) ("We have allowed the temporal proximity of an allegedly fraudulent statement or imission and a later disclosure to *bolster* a complaint, but we have never allowed the temporal proximity between the two, *without more*, to satisfy the requirements of Rule 9(b). . . . We hold the same in the context of the PSLRA") (emph. in original; citations omitted); *see also Shaw v. Digital Equipment Corp.*, 82 F.3d 1194, 1225 (1st Cir. 1996).

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16. *See, e.g., Rothman v. Gregor*, 220 F.3d 81, 92 (2d Cir. 2000); *Novak v. Kasaks*, 216 F.3d at 312-13.

2. The Purported Rejection of the "All Facts" Requirement.

The powerful facts alleged in the Complaint and found to be sufficient by the Second Circuit would, without question, satisfy any circuit court's articulation of the PSLRA pleading standard. Petitioners argue that the Second Circuit applied a more lenient pleading standard than three other circuits because it did not require Plaintiffs to plead "all facts" supporting their allegations. Pet. 18. Instead, the Second Circuit held that Plaintiffs "are required only to plead with particularity sufficient facts to justify those beliefs." *Id.*

The supposedly varying standards between the Circuits are, at best, nothing more than different judges using different words to say the same thing. This is demonstrated by examining the opinion below as a whole, and in the context of Second Circuit jurisprudence, rather than the single out-of-context sentence quoted by Petitioners. Thus, the Second Circuit noted that while a complaint need not include "detailed evidentiary material," it cannot simply rely on an "unsupported general claim of the existence of confidential company sales reports . . . to survive a motion to dismiss." Pet. App. 15a. Rather, the court then went on to state,

> a plaintiff needs to specify the internal reports, who prepared them and when, how firm the numbers were of which company officers reviewed them. Plaintiffs have satisfied this standard by specifying who prepared internal company reports, how frequently the reports were prepared and who reviewed them. We further observe that the complaint gives additional indications as to the nature of the reports, because the allegations are immediately preceded and followed by figures from retailers to show sales were declining.

Pet. App. 15a-16a. The Second Circuit specifically held that the Complaint here met applicable pleading standards, citing

First and Seventh Circuit opinions. *Id.* Indeed, the above-quoted language is completely consistent with the analysis in *Silicon Graphics*, 183 F.3d at 985 ("We would expect that a proper complaint which purports to rely on the existence of internal reports would contain at least some specifics from those reports as well as such facts as may indicate their reliability").

The practical application of the pleading standards are indistinguishable between the various courts. In *Silicon Graphics*, plaintiffs alleged in conclusory fashion that defendants' knowledge of the fraud was demonstrated by internal reports that contradicted the positive statements made to the public. The Ninth Circuit found, however, that the plaintiff "does not plead facts to corroborate her allegations." 183 F.3d at 985. Instead, the plaintiff relied solely on a boilerplate statement about what would be revealed by discovery. *Id.* (quoting complaint). This, according to the Ninth Circuit was "too generic." *Id.*[17]

Contrary to Petitioners' argument, the Ninth Circuit did not require the inclusion of literally all facts in the complaint. Rather, the court deemed sufficient the pleading of "relevant facts" with "some specifics" to establish the reliability of the allegations. *Id.* This is consistent with the Second Circuit's approach here.

Unlike the Complaint *Silicon Graphics*, the allegations in this case (as the Second Circuit correctly recognized) are

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17. *Greebel v. FTP Software, Inc.*, 194 F.3d 185 (1st Cir. 1999), and *Helwig v. Vencor, Inc.*, 251 F.3d 540 (6th Cir. 2001), are similarly inapposite. In *Helwig*, the Sixth Circuit did not address the application of the "information and belief" pleading requirements of the PSLRA other than to quote the statute. 251 F.3d at 550. In *Greebel*, the First Circuit did nothing more than reaffirm its prior decisions under Fed. R. Civ. P. 9(b), which did not require the pleading of every piece of evidentiary material supporting fraud allegations. 194 F.3d at 194.

not based on "generic," conclusory allegations that could be asserted against any corporation whose stock price has declined. Far from a "cookie-cutter" complaint with allegations that have been recycled from case to case, as in *Silicon Graphics*, the Complaint here is painstakingly detailed and is based on a variety of reliable sources quoted or referred to in the Complaint. The Complaint is replete with detailed factual allegations concerning the types of internal reports available and corroborating information from fifteen different distributors about the contents of those reports. Such allegations would pass muster under any standard, including that set forth in *Silicon Graphics*.

3. The Purported Rejection of the "Strong Inference" Standard.

Petitioners suggest that the Second Circuit flouted the PSLRA's requirement that inferences of scienter be "strong," and instead applied a standard that such inferences need only be "reasonable" (or "not unreasonable"), thus creating a conflict among the circuits (as well as with the statute itself). Pet. at 20-22. Petitioners' position is wrong in all relevant respects.

Petitioners' contention that the decision below adopts a "reasonableness" standard for judging inferences of scienter is contrary to the language of the decision itself. The decision clearly uses "reasonableness" language only when discussing inferences involving elements of fraud (such as falsity and materiality) other than scienter. When the decision discusses the scienter element, "strong inference" language as used.[18] The decision below thus conforms precisely to the PSLRA's requirements and to decisions from other circuits on this point.

Petitioners argue that the "Second Circuit accepted any inferences [of scienter] as long as they were 'not unreasonable,' "

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18. The PSLRA's mandate of pleading facts establishing a "strong inference" is limited to allegations of scienter. 15 U.S.C. § 78u-4(b)(2). As to other elements of fraud, the necessary inference may therefore be reasonable.

and specifically that the Second Circuit adopted the traditional Rule 12(b)(6) principle (that the court must "accept[ ] all of the allegations in the complaint as true and draw[ ] all reasonable inferences in favor of plaintiffs . . . .") in assessing the pleading sufficiency of scienter allegations. Pet. at 9.[19] This argument, however, completely misrepresents the decision below.

The Second Circuit acknowledged inferences which were "not unreasonable" only in referring to the post class period announcement of a special charge taken against earnings for an addition to Scholastic's reserves for returned books. The Court noted that is was "not unreasonable" to infer from this charge that Goosebumps trade business was in decline throughout the third quarter. Pet. App. 17a. As this inference was only considered to be supportive (but not determinative) of plaintiffs' allegation that there was a trend of growing returns, according to the PSLRA itself, this allegation is *not even subject to* the "strong inference of scienter" standard.[20]

Petitioners' description of the supposedly varying standards among the circuits create a false dichotomy. According to Petitioners, only the Second Circuit is out of step, due to its supposed application of general Rule 12(b)(6) standards for inferences of scienter. But as set forth above, Petitioners have simply conjured up a pejorative assertion about Second Circuit law on the strength of scienter inferences that is simply untrue and is not related in any way

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19. While the Second Circuit indeed references the traditional Rule 12(b)(6) standard, it appears at the very beginning of the opinion. Pet. App. 8a. When the Court turns to a discussion of scienter, it states clearly that it is governed by the more narrow requirements of the PSLRA. Pet. App. 18a-19a.

20. Even if deemed to support scienter which is discussed in an entirely separate section of the opinion, it is one of many circumstances cited by the Second Circuit which cumulatively reach the "strong inference" benchmark.

to its decision *in this case*. There is no division among circuits on this point, and no issue worthy of a grant of certiorari.[21]

4. Petitioners Failure to Raise any Challenge to the Second Circuit Standard in any of the Proceedings Below Weighs Against Granting Certiorari Because These Issues Have not Been Fully Developed by the Parties or Addressed by the Lower Courts.

In this case, petitioners focus on abstract statements in the Court of Appeals' decision and its routine citation to prior Second Circuit precedent to which petitioner never objected below. Petitioners failed to question, let alone to litigate, the matter of the appropriate pleading standard under the PSLRA in the Second Circuit. Accordingly, this case would be an

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21. Indeed, cases from all circuits continue to include recitations of the traditional Rule 12(b)(6) standards in their post-PSLRA decisions, because that standard does continue to apply other than with respect to inferences of scienter. *Howard v. Everex Sys.*, 228 F.3d 1057, 1060 (9th Cir. 2000) (citations omitted) ("treating the complaint's allegations as true and drawing all reasonable inferences in the plaintiff's favor"); *Nathenson v. Zonagen, Inc.*, 2001 U.S. App. LEXIS 20902 at *9-10 (5th Cir. Sept. 25, 2001) ("[W]e will accept the facts alleged in the complaint as true and construe the allegations in the light most favorable to the plaintiffs."); *City of Philadelphia v. Fleming Companies, Inc.*, 2001 U.S. App. LEXIS 19819 at *22 (10th Cir. Sept. 7, 2001) ("[A]ll well-pleaded factual allegations in the . . . complaint are accepted as true and viewed in the light most favorable to the nonmoving party."); *Theoharous v. Fong*, 256 F.3d 1219, 1224 (11th Cir. 2001) ("We . . . will uphold a dismissal only if it appears beyond doubt that the allegations in the complaint, when viewed in the light most favorable to the plaintiff, do not state a claim upon which relief can be granted."); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001) (*en banc*) ("we must construe the complaint in a light most favorable to the plaintiff, and accept all of [the] factual allegations as true. . . . Our willingness to draw inferences in favor of the plaintiff remains unchanged by the PSLRA.") (internal quotations and citation omitted); Thus, the Second Circuit's reiteration of this black letter law is nothing out of the ordinary.

extraordinarily poor vehicle to address the questions presented as these issues have not been meaningfully reviewed by a lower court.

As this Court recognized, "this Court reviews judgments, not opinions." *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842 (1984); *see also California v. Rooney*, 483 U.S. 307, 311 (1987) (per curiam) (dismissing writ as improvidently granted because "[t]his Court 'reviews judgments, not statements in opinions' ") (quoting *Black v. Cutter Laboratories*, 351 U.S. 292, 297 (1956)). "More particularly, [this Court] review[s] the judgment that the Court of Appeals entered in this case, not the judgment that it may have entered in some other case, or some isolated statement in its opinion commenting on the holding in some other case." *United States v. Doe*, 465 U.S. 605, 620 n.1 (1984) (Stevens, J., concurring in part and dissenting in part). Accordingly, this Court will not review "the *rationale* relied on by the Court of Appeals." *Texas v. Hopwood*, 518 U.S. 1088, 1088 (1996) (statement of Ginsburg, J., joined by Souter, J., respecting the denial of certiorari). "Any conflict in these two formulations [in the lower courts] is of no consequence here." *Johnson v. DeGrandy*, 512 U.S. 997, 1003 n.5 (1994).

II. CERTIORARI SHOULD NOT BE GRANTED TO REVIEW THE SECOND CIRCUIT'S RULING ON THE RELEVANCE OF INSIDER TRADING ALLEGATIONS TO THE PLEADING STANDARDS FOR SCIENTER SINCE THIS HOLDING RELATES ONLY TO DEFENDANT MARCHUK, THERE IS NO SIGNIFICANT CONFLICT AMONG THE CIRCUITS REGARDING THIS ISSUE AND OTHER ALLEGATIONS ALSO SUFFICE TO PLEAD SCIENTER

Certiorari is inappropriate to review the Second Circuit's reliance on insider trading allegations to conclude that the Complaint properly pled scienter. First, this analysis was used exclusively with regard to Petitioner Marchuk. Thus, any grant of certiorari on this issue would not impact the principal case against Scholastic. Second, all the Circuits to reach the issue of motive and opportunity pleading have concluded that insider trading allegations such as those asserted against Marchuk may give rise to a strong inference of scienter. The Complaint adequately pleads facts supporting a strong inference of Marchuk's actual knowledge or reckless disregard of material misstatements and omissions making the appropriateness of a motive and opportunity analysis moot.

A. The Circuit Court Only Considered "Motive and Opportunity" Allegations as to Defendant Marchuk

The Second Circuit's only reference to "motive and opportunity" as a means to plead scienter came in connection with Petitioner Marchuk and his insider trading during the Class Period. Pet. App. 19a-23a. In discussing the allegations against Petitioner Scholastic, the Second Circuit held, correctly, that the Complaint adequately alleged Scholastic's actual knowledge or reckless disregard that it was making false statements and omitting material information from its statements which would mislead investors. Pet. App. 23a-25a. Since the "motive and

opportunity" analysis relates only to one defendant, a grant of certiorari solely on this question would be inappropriate.

B. There is no Inter-Circuit Conflict Concerning Insider Trading Allegations

Contrary to Petitioners' argument, there is no conflict among the Circuits relating to the use of insider trading allegations of the type alleged here to adequately plead scienter. As the most recent Circuit Court to consider the issue observed,

> Putting aside the Ninth Circuit standard, which gives the deletion of the Spector amendment a more pointed reading than it will bear, *the split in the other Circuits is more apparent than real*. As we have discussed . . . , the Second Circuit has dramatically constricted the types of "motive and opportunity" that it will recognize as sufficient to plead scienter. It will not allow plaintiffs to proceed based on widely held motives such as "(1) the desire to maintain a high corporate credit rating or otherwise sustain 'the appearance of corporate profitability, or of the success of an investment, [or] (2) the desire to maintain a high stock price in order to increase executive compensation or prolong the benefits of holding office." *Novak*, 216 F.3d at 307 (internal citations omitted). Even complaints based on insider trading must allege more than that the defendant benefitted from trading because of a false statement or omission; the insider trades have to be "unusual," either in the amount of the profit made, the amount of stock traded, the portion of stockholdings sold, or the number of insiders involved, before they will give rise to the required inference of scienter. *See Rothman v. Gregor*, 220 F.3d 81, 94 (2d Cir. 2000); *In re Advanta*, 180 F.3d at 540-541; *Oran v. Stafford*, 226 F.3d 275, 290 (3d Cir. 2000). This is

> the same kind of inquiry undertaken by courts that do not adhere to the motive-and-opportunity formulation. *See Nathenson*, 2001 WL 1131511, at *16; *Helwig*, 251 F.3d at 552; *Greebel*, 194 F.3d at 198. *The search in the Second Circuit line of cases, as well as in the other circuits, is for facts that give a strong reason to believe that there was reckless or intentional wrongdoing. [citation omitted] Taken as a whole, the cases do not substantiate the fear that courts applying the motive-and-opportunity formulation will permit pleadings to go forward without facts strongly suggesting wrongdoing.*

Florida State Board of Administration v. Green Tree Financial Corporation et al., 2001 U.S. App. LEXIS 22921 at *37-*38 (8th Cir. October 25, 2001) (emphasis added). A close examination of the other Circuit decisions confirms that Petitioners' contention that there exists a substantive conflict among the Circuits is unfounded and that even the Ninth Circuit's decisions would support the sufficiency of the allegations against Marchuk.

Petitioners first point to *Greebel v. FTP Software, Inc.*, 194 F.3d 185 (1st Cir. 1999). After observing that "the words of the Act neither mandate nor prohibit the use of any particular method to establish an inference of scienter," *id.* at 195, the court went on to specifically reject the "argument that facts showing motive and opportunity can never be enough to permit the drawing of a strong inference of scienter," permitting "use of motive and opportunity type pleading if it raises a strong inference." *Id.* at 197. The First Circuit concluded that it was in agreement, not disagreement, with the Second Circuit as well as the Third and Fifth Circuits on this issue. *Id.* ("Three circuits have interpreted the PSLRA as permitting use of motive and opportunity type pleading if it raises a strong inference. *See In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534-35 (3d Cir. 1999); *Press v. Chemical Inv. Servs. Corp.*, 166 F.3d 529,

537-38 (2d Cir.1999); *Williams v. WMX Techs., Inc.*, 112 F.3d 175, 178 (5th Cir. 1997) (dicta)"). Moreover, the First Circuit went on to recognize that "[u]nusual trading or trading at suspicious times or in suspicious amounts by corporate insiders has long been recognized as probative of scienter." *Id.* at 197.

Similarly, in *Helwig v. Vencor, Inc.*, 251 F.3d 540 (6th Cir. 2001) (en banc), the Sixth Circuit observed that regardless of labels, "facts showing [motive and opportunity] may support a strong inference of recklessness" and therefore "may be of enough weight to state a claim under the PSLRA." *Id.* at 551. Agreeing with the First Circuit decision in *Greebel*, the Sixth Circuit emphasized that determining whether such allegations will suffice is a "fact-specific approach." *id.*, and that among the facts relevant to establishing a strong inference of scienter is "insider trading at a suspicious time or in an unusual amount." *Id.* at 552. *Accord City of Philadelphia v. Fleming Companies, Inc.*, 264 F.3d 1245, 1262 (10th Cir. 2001) ("We believe the most reasonable reading of the PSLRA in regard to motive and opportunity pleadings is the view adopted by the First Circuit in *Greebel* and the Sixth Circuit in *Helwig*."). Thus, there is no conflict among the Circuits.

Petitioners attempt to manufacture such a conflict by pointing to the Ninth Circuit's decision in *Silicon Graphics*, *supra*. There, however, after stating the unremarkable proposition that "plaintiffs proceeding under the PSLRA can no longer aver intent *in general terms* of mere 'motive and opportunity" or "recklessness," *id.* at 979 (emphasis added), which was the practice in the Ninth Circuit prior to enactment of the PSLRA, the court went on to specifically reaffirm its long held view that "unusual" or "suspicious" stock sales by corporate insiders could supply a basis for the requisite strong inference. *Id.* at 985-86. *Accord*, *Ronconi v. Larkin*, 253 F.3d at 434-35. Thus, *Silicon Graphics* presents no disagreement with the standard employed by the Second Circuit here.

Finally, Petitioners erroneously point to *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271 (11th Cir. 1999), as being in conflict with the Second Circuit. The *Bryant* court, however, in stating "that a showing of *mere* motive and opportunity is insufficient to plead scienter" was referring to generic motives not at issue here that any court would deem insufficient to plead scienter. The complaint at issue alleged such universal motives as the desire to maintain a high stock price or to reduce bank debt. *Id.* at 1274.[22] The *Bryant* court did not definitively resolve the impact of insider trading allegations, leaving that for the district court on remand. Thus, *Bryant* does not support a material divergence in the Circuit courts on the significance of insider trading allegations of the type alleged against Marchuk here. *See also In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 540 (3d Cir. 1999) ("if the stock sales were unusual in scope or timing, they may support an inference of scienter"); *Nathenson v. Zonagen, Inc.*, 2001 U.S. App. LEXIS 20902 at *52 (5th Cir. 2001) (unusual insider trading would have probative value in analyzing scienter allegations).

Thus, whether phrased in terms of motive and opportunity or direct evidence knowledge or recklessness, there is no disagreement among the circuits that unusual and suspicious insider trading is properly part of the total mix of facts that must be analyzed to determine whether scienter has been pled adequately and may suffice to support a strong inference of scienter.

In the instant case, the Complaint adequately pleads both unusual and suspicious insider trading by Marchuk. Marchuk was a senior corporate officer with access to internal information about sales and returns and was responsible for the Company's

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22. There is no disagreement that "general" claims of motive and opportunity are insufficient to allege the requisite state of mind. *See Helwig*, 251 F.3d at 551 ("pleading conclusory labels of motive and opportunity will not suffice."); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 535 (3d Cir. 1999) (rejecting "blanket assertions" and "catch-all allegations" of motive and opportunity); *Greebel*, 194 F.3d at 197.

contacts with analysts and investors. L. 7 (¶ 14). As of December 30, 1996, Marchuk owned 24,250 shares of Scholastic stock. He had sold no such stock since April 11, 1995, some 20 months earlier. L. 37 (¶ 81), but between December 31, 1996 and January 7, 1997, Marchuk sold 80% of his holdings, or 19,400 shares, for proceeds in excess of $1.2 million. *Id.* Moreover, these sales took place shortly after he participated in the conference call with analysts in December during which he assured analysts that sales were not declining, when in fact they were, that continued 20% growth was reasonable, when in fact it was not, and that the Company was "most comfortable" with earnings projections of around $.64 per share, when in fact the Company was being hit by materially lower sales and higher returns. L. 23-26 (¶¶ 50, 52, 81).

As these facts confirm, the allegations against Marchuk were not based solely on motive and opportunity. As one court has recently noted, that would be an unusual situation.

> Appropriate allegations of motive and opportunity may meaningfully enhance the strength of the inference of scienter, but it would seem to be a rare set of circumstances indeed where those allegations alone are both sufficiently persuasive to give rise to a scienter inference of the necessary strength and yet at the same time there is no basis for further allegations also supportive of that inference.

Nathenson v. Zonagen, 2001 U.S. App. LEXIS 20902 at *52 (5th Cir. 2001).[23]

Based on these factual allegations, the Second Circuit held that the Complaint adequately alleged scienter based on a strong inference emanating from Marchuk's significant and unusual insider sales. Pet. App. 19a-22a. The same result would have been reached in any Circuit.

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23. Indeed, the Second Circuit also noted Marchuk's access to internal Company data regarding book sales and returns. Pet. App. 22a.

III. PETITIONERS' ARGUMENT THAT CIRCUIT AND DISTRICT COURTS ARE CONFUSED ON PSLRA ISSUES IS NOT SUPPORTED BY THE CASES OR THE STUDY CITED, AND IS IRRELEVANT TO THIS PETITION

Petitioners devote their final two pages of the Petition to describing asserted confusion among district courts in applying PSLRA standards, citing a few district court cases (decided *before* their circuits issued determinative decisions) and a "work-in-progress" "discussion paper" (*see* website cited by Petitioners) issued by the John M. Olin Center for Law & Economics just a month before the Petition was filed (Joseph A. Grundfest & A.C. Pritchard, "Statutes with Multiple Personality Disorder: The Value of Ambiguity in Statutory Design and Interpretation" (Aug. 23, 2001) ("Multiple Personality").

The paper offers a statistical analysis of circuit and district court decisions on the PSLRA "motive and opportunity" scienter pleading issue, but does not address the other PSLRA issues raised by Petitioners at all. Multiple Personality at 51. Petitioners' descriptions of the results of the study are misleading. Petitioners imply that the paper's analysis of district court decisions on motive and opportunity, supporting a "coin-toss" model of judicial behavior, applies today. Pet. at 27. The paper, however, makes clear that each district court decision studied "*predates* the issuance of [an appellate] decision addressing the strong inference standard by any panel of the Court of Appeals for the circuit in which the district court resides." *Id.* at 61 (emphasis added). In other words, the paper's conclusion about district court behavior is largely historical and *in*applicable today, since most circuit courts have now interpreted the strong inference provision. *Id.* at 47-50. The Petition's suggestion that the paper found that diverse district court interpretations represent a *current* problem is thus *contrary* to what the paper studied.

With respect to the circuit courts, Petitioners emphasize the paper's suggestion that the Second Circuit "motive and opportunity" pleading standards are too lax, noting reversals of the last four complaint dismissals to reach the Second Circuit. As demonstrated above, however, regardless of the labels employed, there is substantial agreement among the circuits as to the type of facts which will support a strong inference of scienter. *See* Point II, *supra*. Moreover, the fact that the Second Circuit reversed (or remanded) four recent dismissals means nothing as those rulings were justified by the allegations at issue and not any lax legal standard. Indeed, the Second Circuit affirmed a dismissal of an inadequate PSLRA pleading in its most recent decision on the issue, *Kalnit v. Eichler*, 2001 U.S. App. LEXIS 19665 (2d Cir. Sept. 5, 2001). There, the Second Circuit found the motive and opportunity allegations of the complaint, which were predicated on generic motives such as the desire to protect existing compensation arrangements and to avoid personal liability, to be inadequate to plead scienter. The Court contrasted the facts in *Kalnit* with its decision in the instant case, where the inference of scienter flowed from unusual insider trading resulting in specific significant and individualized benefits to the defendant. *Id.* at *23-*24. The difference between the two factual scenarios is dramatic as all courts, not just the Second Circuit, have recognized.

CONCLUSION

For the reasons stated herein, Respondents respectfully pray that the Petition for a Writ of Certiorari be denied.

Respectfully submitted,

STEPHEN A. WHINSTON
Counsel of Record
BERGER & MONTAGUE, P.C.
1622 Locust Street
Philadelphia, PA 19103
(215) 875-3000

JEFFREY A. KLAFTER
BERNSTEIN LITOWITZ BERGER
& GROSSMANN LLP
1285 Avenue of the Americas
New York, NY 10019
(212) 554-1400

Attorneys for Respondents

APPENDIX

APPENDIX — [CORRECTED] SECOND CONSOLIDATED AMENDED CLASS ACTION COMPLAINT DATED MARCH 8, 1999

[Omitted here but submitted separately as Lodging]

Supreme Court, U.S.
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No. 01-397

IN THE

Supreme Court of the United States

SCHOLASTIC CORPORATION and
RAYMOND MARCHUK,

Petitioners,

v.

RICHARD TRUNCELLITO and
THE CITY OF PHILADELPHIA,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF

MICHAEL J. CHEPIGA
Counsel of Record
DAVID E. MASSENGILL
DAVID ELBAUM
SIMPSON THACHER & BARTLETT
425 Lexington Avenue
New York, NY 10017
(212) 455-2000

Of Counsel:

ELLIOTT J. WEISS
CHARLES E. ARES PROFESSOR OF LAW
JAMES E. ROGERS COLLEGE OF LAW
UNIVERSITY OF ARIZONA
1201 East Speedway Boulevard
Tucson, AZ 85721
(520) 621-3578

Attorneys for Petitioners

170737

COUNSEL PRESS
(800) 274-3321 • (800) 359-6859

STATEMENT PURSUANT TO RULE 29.6

Petitioner Scholastic Corporation's Rule 29.6 Statement was set forth at page iii of the Petition, and there are no amendments to that Statement.

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H.R. Conf. Rep. No. 104-369 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730 ..... 1, 10

This case presents three entrenched circuit conflicts over the pleading standards established by Congress in the Private Securities Litigation Reform Act ("Reform Act"). Plaintiffs' effort to rationalize the circuits' competing tests is belied by numerous appellate and district court decisions that recognize the conflicts are real and outcome determinative. The Second Circuit's lenient standards have been rejected in whole or substantial part by at least *seven* circuits.[1] Other circuits repeatedly reach the opposite result on similar facts.

The current state of the law is unacceptable. It is directly contrary to Congress' undisputed intent to create "uniform and more stringent" standards for alleging securities fraud. H.R. Conf. Rep. No. 104-369, at 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 740. Congress found that abusive securities fraud complaints frequently survived motions to dismiss under prior law. As a result, plaintiffs were able to use the discovery process to drive up legal fees, disrupt the defendants' business, and extract a settlement regardless of the merits. Long-term investors ultimately bore these unnecessary costs. *Id.* at 31-32. In order to prevent this wasteful drain on the nation's economy, Congress strengthened the pleading standards to make it "substantively harder for plaintiffs to bring securities fraud cases." *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 196 n.9 (1st Cir. 1999). Congress directed courts to act as gatekeepers *at the pleading stage*, before discovery begins.

This case is the ideal vehicle for this Court to resolve the circuit conflicts over the Reform Act's pleading standards and to make uniform the more stringent standards that Congress intended. Plaintiffs' complaint is typical of the speculative, "fraud by hindsight" securities fraud claims frequently presented to district courts. Filed just weeks after Scholastic announced that sales of a key product had fallen, the complaint alleged, on

1. In addition to the decisions cited in the Petition, *see Florida St. Bd. of Admin. v. Green Tree Fin. Corp.*, Nos. 99-3536, 99-3586, 99-3587, 2001 U.S. App. LEXIS 22921 (8th Cir. Oct. 25, 2001); *Nathenson v. Zonagen, Inc.*, 267 F.3d 400 (5th Cir. 2001); *City of Philadelphia v. Fleming Cos.*, 264 F.3d 1245 (10th Cir. 2001).

information and belief, that Scholastic should have disclosed an ambiguous sales "trend" earlier. Plaintiffs also alleged that a single executive sold Scholastic stock early in the purported class period. The district court twice granted Petitioners' motions to dismiss. The Second Circuit reinstated the complaint, not based on a subtle disagreement about Plaintiffs' allegations, but because it decided that "plaintiffs were held to a more stringent standard than the law requires." Pet. App. 11a. In other words, the choice between competing legal standards under the Reform Act is outcome determinative in this case.

ARGUMENT

The Reform Act requires Plaintiffs to specify the circumstances that constitute the alleged fraud, set forth all facts that support allegations pled on information and belief, and plead with particularity facts that create a strong inference that each defendant acted with fraudulent intent. 15 U.S.C. § 78u-4(b)(1)-(2). In direct conflict with most other circuits, the Second Circuit held Plaintiffs to none of the Reform Act's requirements.[2]

I. This Case Is The Appropriate Vehicle To Resolve The Circuit Split Over The "Motive And Opportunity" Test

Contrary to Plaintiffs' claim that "there is no conflict among the Circuits" (BIO 22), the courts of appeals have repeatedly recognized that they are split on whether "motive and opportunity" allegations are sufficient to establish a "strong inference" of scienter. *See, e.g.*, *Fleming*, 264 F.3d at 1261 ("The courts of appeals are currently split on the question of whether plaintiffs may still use 'motive and opportunity' pleadings to demonstrate scienter under the heightened pleading requirements set forth in the PSLRA."); *Zonagen*, 267 F.3d at 410 ("The Courts of Appeals are divided . . . over the status of the motive and opportunity method.").

The Second Circuit applied a permissive rule based on its own pre-Reform Act case law: Plaintiffs can plead scienter

2. Petitioners are not barred from raising these circuit conflicts. *Contra* BIO 19-20. In the proceedings below, Petitioners were bound by Second Circuit precedent. Also, Petitioners specifically argued that the Second Circuit's standards were too lenient. *See* Petrs. C.A. Br. 32.

by "alleging facts demonstrating that defendants had both the motive and opportunity to commit fraud." Pet. App. 19a. The court found Plaintiffs had satisfied their pleading burden solely by alleging that Marchuk had access to inside information and sold 80% of his Scholastic stock early in the alleged class period. *Id.* 19a-23a. By accepting such bare "motive and opportunity" allegations alone, the Second Circuit never considered whether these allegations actually created a "strong inference" that Marchuk acted with fraudulent intent.[3]

There are two distinct circuit conflicts on this issue. The Ninth Circuit takes the strict view that "motive and opportunity" allegations can never establish a strong inference of scienter. *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 977-79 (9th Cir. 1999). Indeed, the principal case cited by Plaintiffs acknowledged that the legal standards applied by the Second and Ninth Circuits cannot be reconciled. *Green Tree*, 2001 U.S. App. LEXIS 22921, at *35-36.

Ronconi v. Larkin, 253 F.3d 423 (9th Cir. 2001), a decision that Plaintiffs do not seriously attempt to distinguish (BIO 24), illustrates that the Ninth Circuit would reject Plaintiffs' "motive and opportunity" allegations. *Ronconi* affirmed the dismissal of a complaint alleging that an executive vice president sold 98% of her stock during the class period. The court found that this trading, viewed in context, "supports only a weak inference, not a strong one, in light of what the other, equally knowledgeable, insiders were doing." *Id.* at 436. Plaintiffs here did not allege that any other Scholastic officer or director had

3. Plaintiffs argue that "the allegations against Marchuk were not based solely on motive and opportunity." BIO 26 & n.23. Each allegation they cite, however, either (i) goes to whether Marchuk had a "motive and opportunity" to engage in fraud (*e.g.*, he had "access to internal Company data"), or (ii) involves an allegation against Scholastic generally, not Marchuk (*e.g.*, projected 20% sales growth was not "reasonable"). At most, Plaintiffs' argument highlights the difficulty of using "motive and opportunity" allegations in a case involving both individual defendants and corporate defendants (who can form "scienter" only through their employees).

engaged in suspicious trading. But in direct conflict with *Ronconi*, the Second Circuit held that "whether other Scholastic officials sold their stock prior to the February 20, 1997 press release" was "irrelevant." Pet. App. 21a.

The First, Fifth, Sixth, Tenth and Eleventh Circuits also reject the Second Circuit's "motive and opportunity" analysis. These courts have all held that allegations of motive and opportunity may be relevant when analyzing a defendant's state of mind, but "do not constitute a separate, alternative method of pleading scienter." *Fleming*, 264 F.3d at 1261 (citing cases). These courts view "motive and opportunity" allegations only as "an analytical device for assessing the logical strength of the inferences arising from particularized facts pled by a plaintiff." *Zonagen,* 267 F.3d at 411. Such allegations "are typically not sufficient in themselves to establish a 'strong inference' of scienter." *Fleming*, 264 F.3d at 1262. In this case, Plaintiffs have not alleged any unusual facts that would support an exception to the general rule in these circuits.[4]

Indeed, other circuits have held that similar allegations do not create a strong inference of fraudulent intent. Plaintiffs here claimed that a single vice president sold shares worth $1.2 million early in the class period, before Merrill Lynch issued an allegedly manipulated report that upgraded the Company. Pet. App. 41a; 56a. In *FTP Software*, the First Circuit affirmed the dismissal of a complaint that alleged that three executives, including the chief executive officer and chief financial officer, sold a total of $23 million in stock during the class period. 194 F.3d at 206-07. The court found the fact that "[e]ach sold some stock before an allegedly manipulated analyst's report. . . . recommended FTP stock as a long-term buy" refuted any inference of fraud. *Id.*; *see Zonagen*,

4. Plaintiffs are wrong to claim that the "First Circuit concluded that it was in agreement, not disagreement, with the Second Circuit as well as the Third and Fifth Circuits on this issue." BIO 23. In reality, the First Circuit held: "[T]his court has never adopted the Second Circuit test. Instead, we have analyzed the particular facts alleged in each individual case to determine whether the allegations were sufficient to support scienter." *FTP Software,* 194 F.3d at 196.

267 F.3d at 420 (allegation one director sold $1.9 million of stock did not create strong inference of fraud).[5]

II. This Case Is The Appropriate Vehicle To Resolve The Circuit Split Over What Constitutes A "Strong Inference" That Defendants Acted With Scienter

Section (b)(2) requires that courts must be able to draw a strong inference of scienter in order to sustain a securities fraud complaint. Unlike claims governed by Rule 12(b)(6), "the 'strong inference' requirement means that plaintiffs are entitled only to the most plausible of competing inferences." *Helwig v. Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir.) (*en banc*), *petition for cert. filed* (U.S. Sept. 27, 2001) (No. 01-538). As the First Circuit explained in *FTP Software*:

> Congress has effectively mandated a special standard for measuring whether allegations of scienter survive a motion to dismiss. While under Rule 12(b)(6) all inferences must be drawn in plaintiffs' favor, inferences of scienter do not survive if they are merely reasonable, as is true when pleadings for other causes of action are tested by motion to dismiss under Rule 12(b)(6). Rather, inferences of scienter survive a motion to dismiss only if they are both reasonable and "*strong*" inferences.

194 F.3d at 195-96 (citations omitted; emphasis in original).

5. For the reasons discussed in the text, the Eighth Circuit's attempt to reconcile the Second Circuit's decisions with those of the First, Fifth, Sixth, Tenth and Eleventh Circuits, *see Green Tree*, 2001 U.S. App. LEXIS 22921, at *37-40, rests on an unpersuasive reinterpretation of Second Circuit case law. That the Second Circuit's standard is substantially more lenient than the Eighth Circuit supposed is illustrated perfectly by this case and by decisions of district courts in the Second Circuit, which do not require allegations of "motive and opportunity" to give rise to a "strong inference" of scienter. *See, e.g.*, *In re Complete Mgmt. Inc. Sec. Litig.*, 153 F. Supp. 2d 314, 328 (S.D.N.Y. 2001) ("plaintiff's burden on a motion to dismiss is to state [a] motive that, after taking all *reasonable inferences* in the plaintiff's favor, has a sufficient *reasonable possibility* . . . of developing proof that a motive in fact existed") (emphasis added; internal quotation marks omitted).

The Second Circuit refused to follow this statutory mandate. It did not evaluate whether the inferences from Plaintiffs' allegations were "strong" or "the most plausible." Instead, the court simply drew all "reasonable," and even "not unreasonable," inferences in Plaintiffs' favor. Pet. App. 8a, 14a, 17a, 24a. The district court, by contrast, applied a heightened standard and dismissed the complaint.[6]

The Second Circuit's acceptance of allegations that Scholastic engaged in "aggressive sales practices" highlights how its permissive standards conflict with those of other circuits. Pet. App. 16a, 24a. In *FTP Software*, the First Circuit rejected a nearly identical claim on the express ground that any inferences that could be drawn from such sales practices were weak, not strong. Plaintiffs there alleged that a company engaged in aggressive sales practices, which they called "channel stuffing," to shift income to an earlier period by inducing customers to accelerate their purchases. The First Circuit found "nothing inherently improper in pressing for sales to be made earlier than in the normal course." 194 F.3d at 202. The court noted that "channel stuffing" allegations may have "some probative value" as to management's knowledge of low revenues, but held "that value is weak." *Id.* at 203. According to the First Circuit, "there may be any number of legitimate reasons for attempting to

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6. There is no merit to Plaintiffs' claim that the Second Circuit used "'reasonableness' language only when discussing inferences involving elements of fraud (such as falsity and materiality) other than scienter." BIO 17. The court specifically referred to its "discussion in Sections IA and B" in support of its conclusion that, "[a]s to whether plaintiffs adequately pled an inference of scienter, we find they did." Pet. App. 24a. The court incorporated into its scienter analysis the "not unreasonable" inferences it drew with respect to the existence of an alleged negative trend. Thus, the Second Circuit did not simply cite the Rule 12(b)(6) standard at the opening of its decision only to later apply the Reform Act's "strong inference" requirement when analyzing Plaintiffs' scienter allegations.

achieve sales earlier. Thus, it does not support a strong inference of scienter." *Id.*[7]

The Second Circuit compounded its error by lowering the bar for pleading scienter to bare negligence. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197-201 (1976) (§ 10(b) "clearly connotes intentional misconduct"); *see also* Pet. 15 n.1. According to the court, "recklessness is adequately pled for defendants who knew or *should have known* they were misrepresenting material facts with respect to the corporate business." Pet. App. 23a (emphasis added). Applying this standard, the court found that Plaintiffs had "alleged enough to permit proofs that Scholastic *should have been alerted*" to a negative sales "trend." Pet. App. 18a (emphasis added). In *Fleming*, the Tenth Circuit rejected such a diluted standard:

> The requirement of knowledge in this context may be satisfied under a recklessness standard by the defendant's *knowledge* of a fact that was so obviously material that the defendant *must have been aware* both of its materiality *and* that its non-disclosure would likely mislead investors.

264 F.3d at 1261 (emphasis added). The Tenth Circuit would dismiss Plaintiffs' complaint.

III. This Case Is The Appropriate Vehicle To Resolve The Circuit Split Over The Statutory Requirement That Plaintiffs Plead The Factual Basis For Allegations Made On Information And Belief

Plaintiffs must set forth "all facts" that support each allegation pled on information and belief. This critical requirement of § (b)(1) permits courts to evaluate at the outset

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7. The Second Circuit also refused to consider facts alleged by Plaintiffs that undercut their own claim. Most notably, the Second Circuit ignored Plaintiffs' allegation that on November 27, 1996, Scholastic agreed to a $36.1 million, 3½-year contract to acquire dozens more *Goosebumps* books. L. 32 (¶ 67); Pet. App. 37a. The "most plausible" inference to be drawn from Scholastic's execution of this contract is that less than two weeks later — at the start of the alleged class period — Scholastic did not know of a material negative trend in *Goosebumps* sales.

whether allegations are based on facts and reliable sources or mere speculation. Section (b)(1) provides an important foundation for the scienter analysis required in § (b)(2). Unsupported allegations based solely on information and belief cannot give rise to a strong inference of scienter.

The First, Sixth, Eighth and Ninth Circuits demand that complaints specify the source and basis for allegations pled on information and belief. *See FTP Software*, 194 F.3d at 194 ("[T]his court has required plaintiffs who bring their claims on information and belief to set forth the source of the information and the reasons for the belief."); *In re Comshare Inc. Sec. Litig.*, 183 F.3d 542, 553 (6th Cir. 1999) ("[T]heir allegations rest on mere 'information and belief,' and cannot support a strong inference of scienter."); *Green Tree*, 2001 U.S. App. LEXIS 22921, at *65-66 ("[O]ur practice under Rule 9(b) of requiring disclosure of facts relied on for pleadings based on information and belief should obviously be continued under the Reform Act."); *Silicon Graphics*, 183 F.3d at 985 ("[A] plaintiff must provide, in great detail, all the relevant facts forming the basis of her belief.").

The Second Circuit, however, did not require Plaintiffs to identify the basis for any of their allegations against Petitioners, all of which they pled on information and belief. For example, Plaintiffs alleged that Scholastic had access to detailed sales data prepared by its indirect customers and therefore knew or should have known of an alleged negative sales trend. But Plaintiffs never claimed they had seen any documents that supported these allegations or spoken with anyone who had. Nonetheless, the Second Circuit "assum[ed] plaintiffs' allegations to be true." Pet. App. 22a. Plaintiffs' only response to this clear circuit split is to argue that their allegations were "based on a variety of reliable sources quoted or referred to in the Complaint." BIO 17. But they do not (and cannot) point to any support for this claim in their complaint.[8]

8. The allegations that the Second Circuit found "the most egregious" do not satisfy the basic requirement that a fraud claim identify (Cont'd)

The Second Circuit also accepted unsupported allegations that were not pled with particularity. Thus, the court credited Plaintiffs' claim that Scholastic prepared monthly "Director's Books" that "analyzed trade sales data and provided commentary on sales trends." App. 13a. In reality, Plaintiffs merely "identified" these reports. They did not plead their contents — not one number or statistic. And the Second Circuit did not require Plaintiffs to provide this information. Instead, it drew an inference "of the nature of the reports" from other unsupported allegations in the complaint. Pet. App. 16a.[9]

(Cont'd)
the challenged statements with particularity. App. 24a; *see* 15 U.S.C. § 78u-4(b)(1). On January 31, 1997, Merrill Lynch reported that "channel checks as well as discussions with [Scholastic's] management suggest that there has not been a surge in book returns." App. 41a. On February 25, Merrill Lynch issued another report that stated, "Before we upgraded the stock three weeks ago, management indicated that returns were running at normal levels and we received similar guidance even more recently." L. 34 (¶ 71). Plaintiffs did not specify what anyone at Scholastic actually said in these alleged conversations. Nonetheless, the Second Circuit sustained a fraud claim based on an analyst's statements about unspecified "suggest[ions]," "indicat[ions]" and "guidance" received from an unknown member of Scholastic's management at an unknown time under unknown circumstances. A court cannot draw a "strong inference" that statements were made with fraudulent intent if the actual statements are not identified.

9. The Second Circuit accepted numerous other unsupported allegations pled on information and belief that were similarly vague and conclusory. With respect to sales, the court ignored Plaintiffs' admission that Scholastic's business was seasonal according to the school year, which rendered the bulk of Plaintiffs' allegations meaningless because they did not provide sufficient information to make the appropriate comparison of one period to the same prior year period. Most of Plaintiffs' allegations regarding returns were also imprecise. These included allegations that Toys R Us returned "an unusually high amount" of *Goosebumps* books in December 1996 and that returns from a distributor, whose market share Plaintiffs never identified, "began to rise to unprecedented levels" in November and December 1996. Pet. App. 13a,

(Cont'd)

In *Silicon Graphics*, the Ninth Circuit dismissed a similar claim relating to negative information allegedly contained in shipment reports distributed to senior management. The court recognized that every large corporation produces numerous internal reports and, therefore, all plaintiffs could easily allege that their claims would be supported by "negative internal reports." 183 F.3d at 988. To prevent such abusive claims from proceeding to discovery, the Ninth Circuit required plaintiffs to specify the contents of such reports:

> We would expect that a proper complaint which purports to rely on the existence of internal reports would contain at least some specifics from those reports as well as such facts as may indicate their reliability . . . [I]n the absence of such specifics, we cannot determine whether there is any basis for alleging that the officers knew that their statements were false at the time they were made — a required element in pleading fraud.

Id. at 985.

By failing to enforce the Reform Act's requirements, the Second Circuit permitted Plaintiffs to make unsupported, generalized allegations and then engage in discovery to search for facts that might support their claims. Congress enacted the Reform Act to eliminate just this type of abusive "fraud by hindsight" claim. H.R. Conf. Rep. No. 104-369, at 31-32, *reprinted in* 1995 U.S.C.C.A.N. 730, 730-31.

CONCLUSION

Petitioners respectfully submit that the Court should grant a writ of certiorari to review the important issues of federal securities law presented in this case.

(Cont'd)

14a. And Plaintiffs acknowledged that Scholastic did not receive returns information for January 1997 until early February. L. 30 (¶ 58). As the district court correctly found, these allegations are too vague to establish a trend that Scholastic should have disclosed before February 1997.

Respectfully submitted,

MICHAEL J. CHEPIGA
Counsel of Record
DAVID E. MASSENGILL
DAVID ELBAUM
SIMPSON THACHER & BARTLETT
425 Lexington Avenue
New York, NY 10017
(212) 455-2000

Attorneys for Petitioners

Of Counsel:
ELLIOTT J. WEISS
CHARLES E. ARES PROFESSOR OF LAW
JAMES E. ROGERS COLLEGE OF LAW
UNIVERSITY OF ARIZONA
1201 East Speedway Boulevard
Tucson, AZ 85721
(520) 621-3578

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IN THE
Supreme Court of the United States

SCHOLASTIC CORPORATION and RAYMOND MARCHUK,

Petitioners,

v.

RICHARD TRUNCELLITO and THE CITY OF PHILADELPHIA,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MOTION OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* IN SUPPORT OF PETITIONERS AND BRIEF *AMICUS CURIAE*

KELLY M. HNATT
Counsel of Record
787 Seventh Avenue
New York, NY 10019-6099
(212) 728-8000

Attorney for the American Institute of Certified Public Accountants

Of Counsel:

VIRGINIA L. CHAVEZ
WILLKIE FARR & GALLAGHER
787 Seventh Avenue
New York, NY 10019-6099
(212) 728-8000

RICHARD I. MILLER
General Counsel
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
1211 Avenue of the Americas
New York, NY 10036
(212) 596-6200

30pp

MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* IN SUPPORT OF PETITIONER

The American Institute of Certified Public Accountants (the "Institute") hereby respectfully moves for leave to file the attached brief as *amicus curiae* in this case. The consent of the attorney for Petitioners has been obtained. The consent of the attorney for Respondents was requested but refused. The issue presented in this case — the proper pleading standard for scienter under the Private Securities Litigation Reform Act of 1995 (the "Reform Act") — is one of vital interest to the Institute. The Institute is the national organization of the certified public accounting profession. Among other things, it develops authoritative accounting, auditing and ethical standards which, in conjunction with SEC rules, govern independent auditors in reporting on a company's financial statements in publicly filed documents.

In enacting the Reform Act, Congress intended to create uniformity and stringency in the pleading of securities fraud claims, to, among other things, curb strike suits that targeted "deep pocket" defendants such as accountants and other professionals. Since the passage of the Reform Act, however, the circuit courts of appeal have differed drastically in their interpretations of its requirements. Most striking among the circuits' various standards is that applied by the Second Circuit in the present case. Significantly, rather than requiring a plaintiff to plead contemporaneous particularized facts giving rise to a strong inference of knowledge or, at the very least, severely reckless disregard, as required by the Reform Act, the Second Circuit accepted allegations of facts merely indicating what the defendants "should have known" — essentially, "fraud by hindsight" pleading — as well as allegations of "motive and opportunity" alone to establish intent. The brief that the Institute

seeks leave to file as *amicus curiae* joins Petitioners' argument supporting a grant of *certiorari* in this case, but also addresses more broadly the far-reaching implications that the Second Circuit's ruling may have on accountants and other professionals if allowed to stand. As discussed in the attached brief, the less demanding Second Circuit standard renders outside auditors and accountants, whom Congress specifically intended to protect through the passage of the Reform Act, especially vulnerable to securities fraud claims. Because of the nature of the audit process and the client-auditor relationship, plaintiffs can readily claim that an auditor "should have known" about the alleged financial fraud, if there is no requirement that a plaintiff set forth particularized facts regarding the auditor's state of mind.

The conflict among the circuits regarding the Reform Act's pleading requirements has only become more apparent since Petitioners filed their Petition for Writ of Certiorari on August 30, 2001. In the last two months, the Fifth, Eighth and Tenth Circuits have issued opinions interpreting the Reform Act in a manner that is in conflict with the Second Circuit's approach. We believe the need for this Court's resolution of the issue has thus reached a critical juncture. Accordingly, the Institute respectfully requests that this Court grant *certiorari* to the Second Circuit and hear this case.

Respectfully submitted,

Of Counsel:

VIRGINIA L. CHAVEZ
WILLKIE FARR & GALLAGHER
787 Seventh Avenue
New York, NY 10019-6099
(212) 728-8000

KELLY M. HNATT
Counsel of Record
787 Seventh Avenue
New York, NY 10019-6099
(212) 728-8000

Attorney for the American Institute of Certified Public Accountants

RICHARD I. MILLER
General Counsel
AMERICAN INSTITUTE OF
CERTIFIED PUBLIC ACCOUNTANTS
1211 Avenue of the Americas
New York, NY 10036
(212) 596-6200

QUESTIONS PRESENTED

I. Is the Second Circuit's pleading standard for securities fraud lawsuits, permitting plaintiffs to allege securities fraud without pleading either (i) particularized facts specifying how each statement was misleading or (ii) particularized facts giving rise to a strong inference of scienter, inconsistent with the plain language of the statute?

II. Is the Second Circuit's decision inconsistent with the plain language of the statute because it holds, in direct conflict with other courts of appeals, that:

A. A complaint may survive dismissal based solely on inferences that are "not unreasonable," rather than on "strong inferences";

B. A complaint may survive dismissal even though allegations made on information and belief do not include "all facts" on which the belief is formed; and

C. A complaint may survive dismissal where scienter is alleged solely by pleading that a defendant had "motive and opportunity" to commit fraud.

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PRELIMINARY STATEMENT*

The American Institute of Certified Public Accountants (the "Institute") respectfully submits this brief as *amicus curiae*, pursuant to Rule 37.2 of the Rules of the United States Supreme Court, in support of Petitioners Scholastic Corporation and Raymond Marchuk.

INTEREST OF THE INSTITUTE AS *AMICUS CURIAE* AND SUMMARY OF ARGUMENT

The Institute is the national organization of the certified public accounting profession, with more than 330,000 members. Among the Institute's principal purposes are the promotion and maintenance of the highest professional standards of practice. The Institute develops authoritative accounting, auditing, and ethical standards, including ones which, in conjunction with SEC rules, govern independent auditors in reporting on a company's financial statements in publicly filed disclosure documents.

The Institute and its members are vitally interested in this case, which involves a conflict among the circuits not yet addressed by this Court: the proper pleading standard under the Private Securities Litigation Reform Act of 1995 (the "Reform Act"). The Institute has a long-standing interest in the scope and bases of civil liability sought to be imposed on accountants under the federal securities laws. The Institute's predecessor, the American Institute of Accountants, participated in the legislative efforts leading to the Securities Exchange Act of 1934.

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* The American Institute of Certified Public Accountants states that no counsel, other than counsel of record herein, has written this brief, and that no person or entity, other that the *amicus* has made a monetary contribution to the preparation or submission of this brief.

The Institute has continued to participate in legislative efforts involving the federal securities laws, and supported the passage of the Reform Act. The Institute has also participated as *amicus curiae* in numerous cases before the federal courts addressing liability under the judicially implied Section 10(b) private right of action.

In enacting the Reform Act, Congress found specifically that accountants and other perceived "deep pocket" defendants were common targets of "abusive and manipulative" securities litigation "without regard to their actual culpability." Joint Explanatory Statement of the Committee of Conference, Statement of Managers, H.R. Conf. Rep. No. 104-369, at 31-32 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 730-31 ("Conf. Rep."). Plaintiffs in such litigations would claim that fraudulent behavior "must" have occurred because of a restatement or drop in stock price, and the lower courts analyzed defendants' intent under varying standards of "recklessness." As a consequence, class action plaintiffs were able to ensnare accountants in costly, vexatious litigation merely by alleging that they had acted "recklessly" in conducting an audit of a publicly traded company whose stock price had fallen.

The Reform Act was passed to address such abuses. Congress chose, as a principal means of reform, to establish "uniform" and "more stringent" pleading requirements for private securities actions. Conf. Rep. at 41.[1] Thus, Congress

[1] *See also* Hearing on Private Securities Litigation Reform Act of 1995 Before the Senate Subcomm. on Securities of the Comm. on Banking, Housing & Urban Affairs, 105th Cong., 1st Sess. (July 24, 1997) (statement of Richard I. Miller, General Counsel, the Institute) (Reform Act imposes "[a] number of important provisions designed to realign the incentives of the securities litigation system . . . including a heightened pleading standard to filter out boilerplate complaints [and] a safe harbor for forward-looking statements intended to increase disclosure of company information to investors.").

formulated statutory language that was based "in part on the pleading standard of the Second Circuit," the "most stringent pleading standard" at the time, expressly stating, however, that its intent was not to codify that standard, but in fact to "strengthen" it. *See* Conf. Rep. at 41 & n.23.

Far from establishing a uniform and more stringent pleading standard, however, there has been only debate and confusion among federal courts. Most conspicuous among the conflicting scienter pleading standards is that of the Second Circuit, which not only is at odds with the majority of other circuits' interpretation of the Reform Act, but also is in conflict with the plain language of the statute itself. Significantly, the Second Circuit in the present case allowed a complaint to survive dismissal with allegations that established, at most, a *reasonable* inference that the defendant *should have known* about the alleged fraud, rather than a *strong* inference that the defendant *knew or must have known*, as the Reform Act requires.

The conflict among the circuits has become more apparent since the filing of the Petition; in the past two months, the Fifth, Eighth and Tenth Circuits have issued opinions that are inconsistent with the Second Circuit's standard. *See Florida State Bd. of Admin. v. Green Tree Fin. Corp.*, Nos. 99-3536, 99-3586, 99-3587, 2001 WL 1334728 (8th Cir. Oct. 25, 2001); *Nathenson v. Zonagen, Inc.*, No. 99-20449, 2001 WL 1131511 (5th Cir. Sept. 25, 2001); *City of Philadelphia v. Fleming Cos.*, No. 00-6081, 2001 WL 1024039 (10th Cir. Sept. 7, 2001). Without resolution by the Supreme Court of the proper pleading standard under the Reform Act, Congress' intent will remain unreflected, and accountants and others will continue to be exposed to the very risks of abusive Section 10(b) litigation that Congress intended to remedy.

ARGUMENT

I. Congress Intended The Reform Act To Remedy The Rampant Abuse And Manipulation Of Securities Class Actions That It Found Under The Lower Courts' Pleading Standards.

Congress was "prompted by significant evidence of abuse in private securities lawsuits to enact reforms to protect investors and maintain confidence in our capital markets." Conf. Rep. at 31. Congress found that the pleading requirements adopted by the lower courts had permitted "the routine filing of lawsuits . . . whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action." *Id.* Once filed, these strike suits led to "abuse of the discovery process to impose costs so burdensome that it is often economical for the victimized party to settle." *Id.* In the end, Congress found, only the plaintiffs' lawyers benefited without regard to any meaningful recovery by supposedly "injured" investors. *Id.*

Congress also found that these lawsuits especially injured accountants, underwriters, and other third parties. The House and Senate committees heard significant evidence that the class action bar routinely targeted accountants and other perceived "deep pocket defendants" in Section 10(b) class actions "without regard to their actual culpability." Conf. Rep. at 31. This was facilitated by, among other things, the varying standards that courts adopted for alleging recklessness as a theory of scienter under Section 10(b). Under lax pleading standards, even garden variety negligence claims could be brought as Section 10(b) claims simply by pointing to a

restatement and asserting that an accountant had acted "recklessly" in conducting an audit of the issuing company — essentially alleging "fraud by hindsight." "In these and other examples of abusive and manipulative securities litigation," Congress found, "innocent parties are often forced to pay exorbitant 'settlements.' " *Id.* at 32. This abusive litigation resulted in adverse "ripple effects" on the accounting industry, impeding the provision of professional services to market participants, reducing the level and quality of financial reporting, and ultimately injuring the investing public. *Id.*; *see also Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164, 189 (1994).

II. Rather Than Establishing A Uniform And More Stringent Pleading Standard For Federal Private Securities Actions, The Reform Act Has Had The Opposite Result.

Congress determined that the principal means to achieve reform in private federal securities actions was to strengthen the existing pleading standards. As explained in the Conference Committee Report on the Reform Act, Congress decided to establish "uniform and more stringent pleading requirements to curtail the filing of meritless lawsuits." Conf. Rep. at 41.[2] The Conference Committee thus adopted a heightened standard for pleading fraud, which required securities plaintiffs to -

> specify each statement alleged to have been misleading, the reason or reasons why the

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[2] The Conference Committee Report is the "authoritative source for [determining] legislative intent." *Thornburg v. Gingles*, 478 U.S. 30, 44 n.7 (1986).

> statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

15 U.S.C. § 78u-4(b)(1). The Reform Act also imposed a heightened standard for pleading intent, requiring that, with respect to each alleged act or omission, the complaint "state *with particularity* facts giving rise to a *strong inference* that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2) (emphasis added).

Before the passage of the Reform Act, the Second Circuit's pleading standard was seen as the most rigorous among the circuits' various standards. Conf. Rep. at 41 ("Regarded as the most stringent pleading standard, the Second Circuit requirement is that the plaintiff state facts with particularity, and that these facts, in turn, must give rise to a 'strong inference' of the defendant's fraudulent intent."). It provided that scienter could be established with facts (i) demonstrating that defendants had the "motive and opportunity" to commit the fraud, or (ii) otherwise showing "strong circumstantial evidence of conscious misbehavior or recklessness." *See, e.g., Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994). Congress stated that while the language of the Reform Act was "based in part" on the stringent Second Circuit standard, it deliberately omitted from the statute the Second Circuit's language regarding "motive," "opportunity" and "recklessness," stating that its intent was to "strengthen" the pleading standard. *Id.*

The circuit courts of appeal, however, have debated repeatedly whether Congress intended the Reform Act to

codify the Second Circuit's standard for pleading scienter. *See Phillips v. LCI Int'l, Inc.*, 190 F.3d 609, 620 (4th Cir. 1999) ("[A]lthough the new statute indisputably seeks to make pleading scienter more difficult for plaintiffs, there is 'widespread disagreement among courts as to the proper interpretation of the PSLRA's heightened pleading requirement.' ") (citations omitted). As a result, courts have adopted varying standards for pleading scienter, differing in their views on what factual allegations will satisfy the "strong inference" requirement, permitting "recklessness" and interpreting it widely, and disagreeing on whether and to what extent "motive and opportunity" allegations should be a viable substitute for intent. In short, Congress' effort to bring uniformity to the pleading of Section 10(b) claims has resulted in anything but.

III. The Second Circuit's Standard Is Both The Least Stringent Among The Standards Articulated By The Various Circuits And The Most Inconsistent With The Plain Language Of The Reform Act And Congress' Intent.

In stark contrast to the Reform Act's requirement that a plaintiff plead contemporaneous particularized facts indicating a strong inference of defendant's intent, the Second Circuit in *Scholastic* allowed allegations of events that took place *after* the alleged fraud to establish that the defendant "should have known" about the fraud at the time it occurred. That is, the court, at best, permitted "fraud by hindsight" pleading, and, at worst, adopted essentially a negligence standard. The Second Circuit in *Scholastic* also allowed allegations of "motive and opportunity" alone to establish scienter, going against both the majority of circuits to have decided the issue and Congress' intent in enacting the Reform Act.

A. The Second Circuit Permits Allegations Demonstrating That A Defendant "Should Have Known" About The Fraud, Rather Than "Knew Or Must Have Known."

The Reform Act requires a plaintiff to allege with particularity facts that give rise to a strong inference that the defendant acted with the "required state of mind." 15 U.S.C. § 78u-4(b)(2). In the case of an alleged violation of Section 10(b), the "required state of mind" must be gleaned from the statutory language, which expressly requires "manipulative or deceptive" conduct. 15 U.S.C. § 78j(b). As this Court stated in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) ("*Hochfelder*"), this language proscribes only "knowing or intentional misconduct." *Id.* at 197. This Court expressly declined to adopt a subjective recklessness standard in *Hochfelder*, although it observed that under limited circumstances recklessness was viewed in "certain areas" of the law as a form of intentional conduct. *Id.* at 193-94 n.12. After this Court's decision in *Hochfelder*, but before the passage of the Reform Act, many of the circuit courts held that allegations of recklessness sufficed to meet the scienter requirement of Section 10(b), defining reckless conduct as the Seventh Circuit did in *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033 (7th Cir. 1977):

> [R]eckless conduct [is] a highly unreasonable omission, involving . . . an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that it is either *known to the defendant or* is so obvious that *the actor must have been aware of it.*

Id. at 1045 (emphasis added) (citation omitted). *See Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568-69 (9th Cir. 1990);

McDonald v. Alan Bush Brokerage Co., 863 F.2d 809, 814 (11th Cir. 1989); *Broad v. Rockwell*, 642 F.2d 929, 961-62 (5th Cir. 1981); *Mansbach v. Prescott, Ball & Turber*, 598 F.2d 1017, 1024 (6th Cir. 1979); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47 (2d Cir. 1978).

Courts today generally agree that a heightened recklessness of the type defined in *Sundstrand* continues to satisfy the intent requirement the Reform Act, although each circuit presents a different articulation of the precise level of recklessness that the statute requires. *See Greebel v. FTP Software, Inc.*, 194 F.3d 185, 199 (1st Cir. 1999) ("[R]ecklessness does not encompass ordinary negligence and is closer to a lesser form of intent."); *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1286 (11th Cir. 1999) ("We quantify scienter as encompassing at least a showing of severe recklessness. . . ."); *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 977 (9th Cir. 1999) ("[R]ecklessness only satisfies scienter under § 10(b) to the extent that it reflects some degree of intentional or conscious misconduct."); *In re Comshare Inc. Sec. Litig.*, 183 F.3d 542, 550 (6th Cir. 1999) (recklessness is "a mental state apart from negligence and akin to conscious disregard").[3] More important than the differences in how courts characterize the proper level of recklessness, however, is the type of allegations they deem adequate to satisfy even a heightened recklessness standard. The Tenth Circuit recently held that

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[3] While the question of whether recklessness suffices to establish intent has not been raised by the parties in *Scholastic*, and is no longer heavily debated by the circuit courts of appeal, the Institute notes that this Court has not yet spoken on the issue, and submits that the legislative history of the Reform Act strongly suggests that Congress intended the required mental state for Section 10(b) claims to surpass recklessness.

in order to meet the *Sundstrand* definition of recklessness in a Section 10(b) claim, a plaintiff must allege the "defendant's knowledge [at the time of the fraud] of a fact that was so obviously material that the defendant *must* have been aware both of its materiality and that its non-disclosure would likely mislead investors." *City of Philadelphia v. Fleming Cos.*, No. 00-6081, 2001 WL 1024039, at *10 (10th Cir. Sept. 7, 2001) (emphasis added).

By contrast, the Second Circuit, while purporting to adopt the stringent recklessness definition in *Sundstrand* (*see Novak v. Kasaks*, 216 F.3d 300, 308 (2d Cir.), *cert. denied*, 531 U.S. 1012 (2000)), has demonstrated a tolerance for scienter allegations that essentially support mere negligence. That is, rather than requiring a plaintiff to allege with particularity facts giving rise to a *strong* inference that plaintiff *knew or must have known* about the fraud, it allowed a complaint to survive dismissal based on allegations that created a *reasonable* inference that a defendant *should have known*. Specifically, the Second Circuit in *In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63 (2d Cir.), *petition for cert. filed*, 70 U.S.L.W. 3164 (U.S. Aug. 30, 2001) (No. 01-397), held that "post-class period data may be relevant to determining what a defendant knew or *should have known* during the class period." *Id.* at 73 (emphasis added). Additionally, the court permitted allegations of defendants' access to certain information during the class period to establish that they "*should have known* they were misrepresenting material facts with respect to the corporate business" at the time they allegedly had this access. *Id.* at 76 (emphasis added). The Second Circuit thus diluted the quality of pleadings required to establish a fraudulent state of mind, effectively lowering the level of scienter that must be pled under the Reform Act, to negligence.

B. The Second Circuit's Allowance Of "Motive and Opportunity" Alone To Establish Scienter Permits Section 10(b) Complaints To Survive Motions To Dismiss With Less Than A Strong Inference Of Scienter.

The Second Circuit's continued holding here, that a showing of "motive and opportunity" suffices to establish scienter, further demonstrates its acceptance of allegations that do not give rise to a strong inference of knowledge or, at least, severe recklessness. Prior to the passage of the Reform Act, several circuit courts of appeals had held that plaintiffs could allege through facts showing a defendant's "motive and opportunity" to commit securities fraud; that is, that defendants benefited in some concrete and personal way from the purported fraud, such as when the defendants made material misrepresentations to maintain a high stock price, while selling their own shares at a profit. *See generally Chill v. General Elec. Co.*, 101 F.3d 263, 267-68 (2d Cir. 1996).

Today, the circuits are divided on the question of whether plaintiffs may still use "motive and opportunity" pleadings to demonstrate scienter under the heightened pleading requirements of the Reform Act. Only the Second and Third Circuits have reaffirmed their pre-Reform Act position that evidence of motive and opportunity to commit securities fraud may still satisfy the scienter pleading requirements. *See Press v. Chemical Inv. Servs. Corp.*, 166 F.3d 529, 537-38 (2d Cir. 1999); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534-35 (3d Cir. 1999).

Most other circuits that have decided the issue, however, have held that while motive and opportunity may be *relevant* as evidence that contributes to an overall showing of scienter,

they do not alone constitute a separate, alternative method of pleading scienter. *See City of Philadelphia*, 2001 WL 1024039, at *11; *Helwig v. Vencor, Inc.*, 251 F.3d 540, 550-51 (6th Cir.), *petition for cert. filed* (U.S. Sept. 27, 2001) (No. 01-5138); *Greebel*, 194 F.3d at 197; *Bryant*, 187 F.3d at 1282-83. This conclusion supports the Reform Act's requirement that a plaintiff plead facts giving rise to a "strong inference" of scienter. *See Nathenson v. Zonagen, Inc.*, No. 99-20449, 2001 WL 1131511, at *8 (5th Cir. Sept. 25, 2000). Indeed, motive and opportunity are *not* the equivalent of a substantive scienter standard, and to allow such allegations to take the place of facts giving rise to a strong inference of recklessness or conscious misbehavior would "allow potentially frivolous lawsuits to go forward with only minimal allegations of scienter." *City of Philadelphia*, 2001 WL 1024039, at *12.

IV. The Less Stringent Pleading Standard Of The Second Circuit Renders Accountants and Auditors Especially Vulnerable To Frivolous Section 10(b) Claims.

As a result of its decision in *Scholastic*, the Second Circuit has, among other things, opened the door to fraud by hindsight pleading and allegations of fact that give rise to an inference essentially of negligence, as well as minimal "motive and opportunity pleading." As discussed below, this result holds particularly dire consequences for auditors and accountants, and essentially returns the jurisprudence to that which existed pre-Reform Act.

A. Allowing Allegations That A Defendant "Should Have Known" About The Fraud Will Only Encourage The Second-Guessing Of Auditors And The Audit Process That The Reform Act Sought To Avoid.

Allegations giving rise to a *reasonable* inference that a defendant "should have known" about a fraud can be especially harmful to outside auditors and accountants because of the nature of the audit process, which depends on estimates and the exercises of judgment:

> [A]n audit report is not a simple statement of verifiable fact that . . . can be easily checked against uniform standards of indisputable accuracy. . . . Although ultimately expressed in shorthand form, the report is the final product of a complex process involving discretion and judgment on the part of the auditor at every stage.

Bily v. Arthur Young & Co., 834 P.2d 745, 763 (Cal. 1992). Under the lesser pleading requirements articulated and applied by the Second Circuit in *Scholastic*, plaintiffs could avoid dismissal simply by alleging, in a restatement case, for example, that conspicuous warning signs "must" have existed that were available to the auditor during the audit, and thus, the auditor "should have known" about the accounting errors. *See In re SmarTalk Teleservs., Inc. Sec. Litig.*, 124 F. Supp. 2d 505, 516 (S.D. Ohio 2000) (rejecting as hindsight pleading plaintiffs' argument that the magnitude of the accounting error established that the auditors "should have known" of GAAP violations); *but see Rehm v. Eagle Fin. Corp.*, 954 F. Supp. 1246, 1256 (N.D. Ill. 1997) ("The more serious the error, the less believable are

defendants' protests that they were completely unaware of [the Company's] true financial status and the stronger is the inference that defendants must have known about the discrepancy.").

Indeed, the greater the restatement, the greater the likelihood that the complaint will survive a motion to dismiss, without regard to whether plaintiff alleged any specific facts indicating what the auditor actually knew or must have known at the time of the alleged fraud. *See Reiger v. Price Waterhouse Coopers LLP*, 117 F. Supp. 2d 1003, 1013 (S.D. Cal. 2000) ("Inferring scienter from the magnitude of [the] fraud invites a court to speculate as to the existence of specific (but unpled and unidentified) warning signs that show the accountant acted with scienter."); *but see In re Microstrategy, Inc. Sec. Litig.*, 115 F. Supp. 2d 620 (E.D. Va. 2000) (allegations regarding nature of restatement, *i.e.*, number, size, timing, frequency, and context, can raise strong inference of scienter).

Rather, to plead scienter in accordance with the Reform Act, a plaintiff should be required to identify "specific, highly suspicious facts and circumstances available to the auditor at the time of the audit" that "were deliberately ignored or must have been known." *In re SmarTalk Teleservs. Sec. Litig.*, 124 F. Supp. 2d at 514; *see also In re Ikon Office Solutions, Inc. Sec. Litig.*, 66 F. Supp. 2d 622, 629 (E.D. Pa. 1999) (plaintiff alleged that accountant's file contained handwritten note revealing that client's management had told him an employee was "cooking the books"); *In re Health Mgmt., Inc. Sec. Litig.*, 970 F. Supp. 192, 203 (E.D.N.Y. 1997) (plaintiff alleged that accountant possessed letter from analyst with specific warning that client had improperly inflated accounts receivable).

Accepting lesser allegations of what a defendant "should have known," as permitted by the Second Circuit, would also allow plaintiffs improperly to fault auditors for the conduct of their client. A plaintiff could merely allege, based on the closeness of the relationship with the company and access to information, the auditor "should have known" about the client's fraud. *See In re Reliance Sec. Litig.*, 135 F. Supp. 2d 480, 510 (D. Del. 2001) (genuine issue of fact existed as to what KPMG "knew or should have known" with regard to the accounting fraud, because of the information that was available to it); *Danis v. USN Communications, Inc.*, 73 F. Supp. 2d 923, 942 (N.D. Ill. 1999) (denying motion to dismiss; auditor was alleged to have had "sufficient contact" with company to "become aware of [its] fraudulent abuses and pervasive and fundamental internal control problems"); *but see Reiger*, 117 F. Supp. 2d at 1009 (nine-year relationship and familiarity was not enough to impute accountant with knowledge of every detail of client's business). This flies squarely in the face of Congress' intent in adopting a heightened pleading standard.

B. "Motive and Opportunity" Alone Cannot Be Enough To Establish An Outside Auditor's Intent To Defraud.

The inadequacy of motive and opportunity pleading alone as a basis for fraudulent intent is especially apparent in the case of independent auditors, for whom the standard should be largely inapplicable. As one court put it, auditors

> will rarely, if ever, have any rational economic incentive to participate in its client's fraud. . . . [A]n independent auditor has no ability to line its pockets through insider trading, and no incentive

> to cover up corporate mismanagement. The accountant's success depends on maintaining a reputation for honesty and integrity, requiring a plaintiff to overcome the irrational inference that the accountant would risk its professional reputation to participate in the fraud of a single client.

Reiger, 117 F. Supp. 2d at 1007. Indeed,

> in the absence of evidence that an outside accountant has become an insider in the subject company, e.g., by purchasing stock whose value is then inflated by the misstatements, it appears unlikely for any plaintiff ever to demonstrate sufficient motive to provide a strong inference pursuant to the motive and opportunity test that an outside accountant or accounting firm committed fraud.

Retsky Family Ltd. P'ship v. Price Waterhouse LLP, No. 97 C 7694, 1998 WL 774678, at *9 (N.D. Ill. Oct. 21, 1998).

Nevertheless, were motive and opportunity to remain as an alternative mode of pleading scienter, as permitted by the Second Circuit in the present case, creative plaintiffs would find ways to allege a "concrete benefit," other than a fee, that the auditor could obtain by maintaining its relationship with the client company — for example, the auditor's desire to maintain a competitive position vis-à-vis other accounting firms. *See In re Resource America Sec. Litig.*, No. Civ. 98-5446, 2000 WL 1053861, at *8 (E.D. Pa. July 26, 2000) ("[T]he motive alleged — that is, the desire to maintain its competitive position as to other accounting firms by retaining

three substantial and interrelated clients — gives rise to a strong inference of scienter."). There would be a high probability, however, that such litigation-induced "motives," standing alone, would be irrelevant to whether the auditor knew or must have known about the company's fraud.

V. The Issue Of The Pleading Requirements Under The Reform Act Is Ripe For Review By The Supreme Court.

Congress' intent in passing the Reform Act was absolutely clear — to put in place a significant statutory pleading hurdle for Section 10(b) actions that would curtail meritless claims, including particularly those brought against the accounting profession, and establish uniformity in pleading among the circuits. As discussed above, however, Congress' intent has in no way been achieved, as courts have interpreted and applied the pleading requirements of the Reform Act widely. The result is a lack of uniformity in the pleading standard from circuit to circuit, confusion in the application of those standards among the district courts, and a tendency, begun by the Second Circuit, to slip back to a pre-Reform Act era of pleading. Resolution by the Supreme Court is crucial to establish the uniformity and stringency that Congress intended. Accordingly, the Institute respectfully requests that a writ of certiorari be granted so that the Supreme Court may review the judgment of the Second Circuit.

CONCLUSION

For the foregoing reasons, the Institute respectfully submits that the Petition of Scholastic Corporation and Raymond Marchuk should be granted.

Respectfully submitted,

KELLY M. HNATT
Counsel of Record
787 Seventh Avenue
New York, NY 10019-6099
(212) 728-8000

Attorney for the American Institute of Certified Public Accountants

Of Counsel:

VIRGINIA L. CHAVEZ
WILLKIE FARR & GALLAGHER
787 Seventh Avenue
New York, NY 10019-6099
(212) 728-8000

RICHARD I. MILLER
General Counsel
AMERICAN INSTITUTE OF
CERTIFIED PUBLIC ACCOUNTANTS
1211 Avenue of the Americas
New York, NY 10036
(212) 596-6200